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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1983

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

FEBRUARY 16, 18 AND 22, 1983

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1983

WEDNESDAY, FEBRUARY 16, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Hawkins, Mattingly, Hecht, Proxmire, Riegle, Sarbanes, Dixon, Sasser, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

Chairman Volcker, we're pleased to have you before the Senate Banking Committee this morning. This hearing on monetary policy is occurring at a critical time for our economy.

An increasing number of indicators point to an incipient economic recovery, but most analysts agree that this recovery remains very fragile. To a large extent the continuation of the recovery is contingent upon a continuation of the recent upturn of housing, an industry for which this committee has a special responsibility. A continuation of the upturn in housing, in turn, is dependent on what happens to interest rates.

This committee held very extensive housing hearings on Monday of this week, some 4½ hours. Everybody was in agreement on one point, and there was a wide diversity of groups testifying. Everybody was in agreement that interest rates are the key to the continuation of the upturn in housing starts, and although the witnesses certainly differed on how we should achieve a reduction in the Federal deficit, they agreed that deficits are the key to the reduction of interest rates.

There are recent developments that must give us some concern. Treasury bill rates are no lower than they were in late August. Long-term Treasury yields are higher than they were in November and December. Many analysts blame this failure of interest rates to continue to decline on the acceleration of growth in the monetary aggregates. Over the last 6 months M_1 has grown at an annual rate of over 12 percent and M_2 has grown at an annual rate of over 13 percent. On the other hand, some acceleration in the aggregates' growth rates clearly was justified by the maturing of all-savers certificates, the availability of new market rate deposit instruments, and declining interest rates.

Fears have been expressed that the fourth-quarter acceleration in the aggregates' growth rates has been more than justified by structural changes. Whether or not these fears are well founded, we now know that such psychological factors can have major impacts on the financial markets.

Our No. 1 priority must be to resume the downward trend in interest rates. To accomplish this, we must return to monetary aggregate growth rates that will convince the financial markets that the Federal Reserve and this Government remain committed to the fight against inflation.

Mr. Chairman, you and I have had many discussions over the past several years. I would repeat only briefly that you know how strongly I feel that the major blame for high interest rates lies with the Congress of the United States. Rates are held high by the need to refinance one-third of a trillion, $300 billion outstanding debt every year; our continually increasing deficits, year after year; and the unwillingness to come to grips with these deficits despite all of the rhetoric. Once again we probably are facing a $200 billion deficit, and each one of the deficits over the last 3 or 4 years has always been considerably larger than the initial estimates. Regretably I have no reason to believe that that will not be the case again.

I certainly have not always been complimentary or uncritical of the performance of the Fed. But I do think that monetary and fiscal policy have to be coordinated and work together. No matter whether it was you or someone else as Chairman of the Federal Reserve Board, if you have to plan to monetize 150 to 200 billion dollars' worth of deficit each year, you have no choice in that matter. That is the responsibility of Congress for continuing to send those large deficits to you. I think we have to do a better job on both fronts with Congress bearing the major portion of the blame, no matter how much people may wish to use the Fed as a scapegoat for all the problems. I wish they would direct more of their criticism at where I believe it really belongs, and that is at the House and the Senate of the United States. I do hope in these hearings that we can have some enlightenment where you think interest rates are going and what you expect your policy as Chairman of the Fed will be in light of the difficulties of fiscal policy, how we best can work together to lower those deficits, and hopefully have interest rates continue to go down, not just stay at the level of a lower rate than they have been but continue to go down so that this recovery, however much it is in its infancy, is not aborted.

Senator Proxmire, do you have an opening statement you wish to make?

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, in the 25 years I have been on this committee, I don't think I've ever seen this room as completely filled as it is now. You said that you were asked why we couldn't get a bigger hearing room and that was a pretty good question, but I think the reason why we have this turnout is because, Chairman Volcker, I think you recognize that you're the key man in what's going to

happen to our economy and the world economy for that matter in the next year or so.

The head of the IMF just said the other day that the most serious obstacle to worldwide recovery is the size of the Federal deficit in the United States, a statement with which I very enthusiastically agree. We simply have to act on that and, of course, corollary to that, is that we face the prospect of very, very high interest rates which will not only, as the Chairman so ably said, press our economy and keep us from having a bigger recovery, but is likely to affect the whole world economy and pose a very, very serious problem.

Let me just say in connection with your appearance this morning that in its 1982 report to the Congress, the Board substantially overestimated the underlying strength of the economy and substantially underestimated the demand for money and other liquid balances. Because of the sharp increase in the demand for M_1 balances, the Board's original monetary growth targets were well below the level required to finance the economy.

For example, if the Fed had stuck with its original target for holding the growth of M_1 to an upper level of 5.5 percent, nominal GNP would not have grown at all while real GNP would have declined even below the -1.2 percent growth actually experienced.

The problem of selecting the appropriate guideposts for monetary policy will be even more difficult in 1983 because of the new deposit accounts that became available from deposit institutions in December and January. As of January 26, 1983, $213 billion was placed in the new money market deposit accounts and $17 billion in Super NOW accounts.

Another problem concerns the divergence between the Fed's announced targets and what it actually does. When the Fed shifted to a more accommodative policy in the latter part of 1982, it did not formally notify the Congress it was raising its target even though the law specifically provides such an opportunity each July. One reason may have been a desire to avoid raising inflationary expectations through a formal increase in the official targets. Nonetheless, this flexible approach raises questions about the relevance of the targets that are set forth and the accountability of the Fed to the Congress in meeting them.

I might add that in spite of all the criticism, the country is lucky to have you as Chairman of the Fed. I think you've done a remarkable job under the most difficult circumstances and I hope you can continue.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, I'm not going to make an opening statement. I have a lot I want to ask Mr. Volcker about.

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Mr. Chairman, thank you. I'll be very brief.

There are signs of a limited economic recovery perhaps starting now and we all hope that that is the case, but over the last few weeks, as you well know, there's been an uptake in interest rates which has really given everybody a bad case of the jitters. We have

had people in from the housing industry before this committee in the last couple days and they are nervous.

We spoke just before the hearing started about auto sales and as you know they are described in today's paper by the analysts as being mediocre. There's been some improvement there but a lot of that has been due to special financial incentives that the companies themselves have offered.

The concern I have is that it looks like interest rates may have bottomed out and may bump along at about correct interest levels for a period of time and, if so, that makes me very apprehensive because I don't think interest rates at current levels will let us get a real and sustained economic recovery going.

Now I think almost every Member of the Senate would say that we need a fiscal tightening the budget. The problem is that it will be at best a few months before the budget process is finished and in the meantime, it looks to me as if interest rates have to go lower. Given all of the slack in the economy, a third of the plant and equipment sitting idle, 12 million people out of work—we need fiscal tightening with monetary easing. The Board lowered the discount rate in a series of steps last year and helped get interest rates down, but there have been no further changes or reductions in the discount rate. I would hope there would have been, with the thought in mind that the Congress is committed to the fiscal tightening that we need.

I would hope today you will give us reason to believe that they may go lower, at least somewhat lower, in the near term so that we could really start to get some momentum on the upside in terms of recovery.

The CHAIRMAN. May I just say to my friend from Michigan that with all of my children we are doing our part. We have six cars among us and if we get more people to do their part it would help the Senator from Michigan considerably.

Senator Mattingly.

Senator MATTINGLY. No comment at this time.

The CHAIRMAN. Senator Dixon.

Senator DIXON. No opening statement, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. No.

The CHAIRMAN. We have a statement of Senator Hawkins which we'll insert in the record at this point as though read.

[Statement follows:]

OPENING STATEMENT OF SENATOR HAWKINS

Senator HAWKINS. Chairman Volcker, it is a pleasure to have you before the Senate Banking Committee today. As you know, I have always been very interested in the Federal Reserve System. In October 1981, I introduced legislation to reform the Fed System by restructuring the Board of Governors and requiring that the expenditures of the Federal Reserve System be approved by Congress as part of the annual appropriations process. At least 8 other bills were introduced in the 97th Congress calling for a restructuring of the Board of Governors. Senator Garn, as chairman of the Senate Banking Committee, held hearings on the Federal Reserve Board

membership and structure. Senator Garn said at that time that he did not believe that recent appointments to the Board created a membership that, as is intended in the Federal Reserve Act, represented the broad range of geographical and economic interests of this country. I hope this is an issue which will receive further attention in the 98th Congress.

Now, I look forward to the Monetary Policy Report for 1983.

The CHAIRMAN. Mr. Chairman, it's all yours.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, FEDERAL RESERVE

Mr. VOLCKER. Mr. Chairman, I am pleased to be meeting again with this committee to discuss the Federal Reserve's objectives for monetary policy and their relationship to the prospects for the economy. You already have received the official monetary policy report to Congress that is required under the Humphrey-Hawkins Act. My comments today will expand upon some of the points raised in that report, focusing in particular on our objectives with respect to monetary policy and the obstacles that, unless dealt with effectively, could deflect the economy from the path of sustained expansion we would all like to see.

Our economy has been going through wrenching adjustments during the past year and a half. With production falling into sharp recession, the unemployment rate rose to a postwar high. A large share of our industrial capacity is idle. Profits are depressed, and there have been exceptionally large numbers of business failures.

Conditions in most other industrialized countries, in greater or lesser degree, have paralleled those in our own economy, and large sectors of the developing world have faced the need for forceful measures to deal with internal and external imbalances. All of this has been reflected in, and accompanied by, pressures on domestic and international banking markets.

At the same time, out of this turmoil and stress we can see elements of change and returning strength that bode well for the future. In particular, striking progress has been made in reducing inflationary pressures. The measured rate of inflation in 1982 was the lowest in a decade, and forces are at work that, carefully nurtured, can continue that progress during recovery. Interest rates have fallen substantially from the high levels of the past couple of years; as confidence builds that inflation can be held in check, further declines should be sustainable. Business and labor have responded to the market forces by taking measures to cut costs and improve efficiency, and those measures should have a healthy effect long after the recession has passed.

At the turn of the year, signs appeared that the decline in economic activity was ending and that recovery might soon develop. Housing construction, auto sales, and factory orders have all improved in recent months. The sharp downturn in unemployment reported in January should be interpreted cautiously in the light of the month-to-month volatility of those estimates, but indications of some firming in labor demand are heartening.

In sum, this has been a time of disappointment and strain—but also a period of great potential promise. That promise lies in the

prospect that, under the pressure of events, we—in Government, in business and labor, and in finance—are facing up to what is needed to sustain recovery into long years of healthy growth.

I know that this has also been for many a time of frustration and doubt. Unemployment of a willing worker is always a threat to personal and family stability; on a wide scale it is an affront to our sense of social justice. To a generation grown accustomed to accelerating inflation, a year or two of progress toward price stability simply isn't enough to quell fears that the earlier trend will resume as the economy picks up speed. We have been disappointed before when early signs of recovery faded away. Federal deficits persisting at levels beyond any past experience are unsettling to more than financial markets. We have been jarred to the realization that a serious international financial disturbance is not just something we read about in books of economic history but could recur unless we are alert to the dangers and deal aggressively with them.

Uncertainty and confusion are perhaps inevitable in a period of change—even constructive change. But they can easily be destructive without a clear conception of where we want to go and how to get there. My conviction is that much of the stage has been set for long lasting, noninflationary expansion. But we also have to be realistic and clear-sighted about the threats and obstacles that remain, confident that being known, they can be cleared away.

THE PROSPECTS FOR STABLE GROWTH

The unchanging goal of economic policy, embodied in the Employment and Humphrey-Hawkins Acts, has long been growth in employment, output and productivity at relatively stable prices. That goal for a decade and more increasingly eluded us, not least because of an illusion for a time that the stability side of the equation could be subsidiary. Once inflation gained strong momentum, it was doubly hard to contain without transitional pain. But after several years in which the effort against inflation has had high priority, there are today solid grounds for believing the signs of incipient recover can be the harbinger of performance much more in line with our goals.

We approach our discussion on monetary policy with the intent of fostering that result. But, of course, monetary policy alone cannot do the job; other instruments of policy and the attitudes of business and labor will be crucial as well.

The latest price statistics confirm the progress against inflation. But the fact that all the major inflation indices increased by 5 percent or less during the course of last year—or that the producer price index actually dropped in January—does not mean that the battle is won.

Those gains have been achieved in the midst of recession, with strong downward pressures on prices and costs from weak markets. We cannot build a successful policy against inflation on continued recession. The question remains as to how prices will behave as the economy recovers—after 6 months or a year of rising orders, employment, and production.

In recent weeks, increases in some highly sensitive commodity prices have been cited as a danger sign. Those commodities are subject to speculative influences, but, surely, an increase in some prices that have been severely depressed during recession is not itself a signal of change in more basic price trends.

One widely used index of sensitive industrial commodity prices—excluding oil—declined by about 35 percent from the end of 1980 through late 1982, carrying many of those prices to levels that could not justify new investment or even maintenance of existing output. Within limits recovery in those prices would be a natural, and probably necessary, part of any expansion and will not dominate more general price statistics.

In fact, the single commodity of major importance to the general price level—oil—is in surplus supply, and the price in real terms has been declining. I cannot prophesy the degree to which the nominal price of oil might decline in coming weeks or months, if at all. But barring a major political upset, prospects appear exceptionally good that stable or falling real prices for finished petroleum products—which account for 8–9 percent of the GNP—can reinforce progress against inflation for some time ahead. We also have large stocks of basic food commodities, providing some assurance against a sharp runup of prices in that area.

It is labor costs that account for the bulk of the value of what we produce, and our success against inflation in the longer-run will need to be reflected in the interaction of wages, productivity, and prices. It is also in this area that recent signs of progress can prove most lasting.

The upward trend of nominal wages and salaries slowed noticeably last year, with average wages rising by about 6 percent from the fourth quarter of 1981 to the fourth quarter of 1982; total compensation, including fringes rose just over 6½ percent. The trend during the year seemed to be declining, and in the midst of pressures on profits, markets, and employment, could well show further declines. The sharply lower inflation figures—below the rate of wage increase—moderate one source of upward pressures on new wage agreements. Longer-term union agreements negotiated in earlier more inflationary years are expiring, tending to further moderate the wage trend.

The slower increases in nominal wages have been fully consistent with higher real wages for the average worker precisely because the inflation rate has been declining. Continuation of that benign interaction among lower inflation, lower nominal wages, and higher real wages—combined with recovery in profits—must be a central part of noninflationary recovery—and thus to sustaining expansion.

Those prospects will be greatly enhanced by improved productivity performance; over time, only an increase in productivity can assure higher real wages and profits. Happily, after dwindling away to practically nothing during the 1970's, the signs are that productivity is rising once again. Tentative evidence can be found in preliminary data suggesting productivity rose by almost 2 percent last year in the midst of recession, an unusual development when production is declining. Those statistics are consistent with

reports from business that significant progress has been made in improving efficiency and in reducing "break-even" points.

During the early part of recovery, productivity usually grows more rapidly. Consequently, a combination of rising cyclical and "trend" productivity with more moderate nominal wage gains should reduce the increase in unit labor costs further as a recovery takes hold. For example, a rise in hourly compensation of less than 6 percent this year would appear consistent with recent trends. Should productivity increase by 2-2½ percent—an expectation that would appear modest in the light of recent experience—unit labor costs would rise by significantly less than 4 percent, low enough to maintain and reinforce progress on the price front.

As confidence grows that the gains against inflation are sustainable, an expectation of further declines in interest rates should be reinforced. Today, short and particularly longer-term, interest rates, despite the large declines last year, remain historically high in nominal terms and measured against the current rate of inflation. A number of factors contribute to that, including the present and prospective pressures from heavy Treasury borrowing. But concerns that recent gains against inflation may prove temporary are checking the decline in interest rates.

We will certainly need higher levels of investment and housing as time passes to maintain productivity, to support real income gains, and to keep supply in balance with demand. Lower interest rates are certainly important to that outlook, but what is essential is that those lower levels can be sustained over time. That is one reason why policies need to remain strongly sensitive to the need to maintain the progress against inflation—uncertainty on that point will ultimately be self-defeating in terms of the interest rate environment we want.

An improved climate for work, for saving, and for investment—the objective of the tax changes introduced in 1981—should also materialize in an economic climate of recovery and disinflation, helping to keep the process going. Rising real incomes will also be reflected in consumer demand—an area of the economy already supported by the large deficits. As living standards rise and fears of inflation fade, pressures for excessive and catch-up wage demands should subside.

In sum, there are strong analytic reasons to believe that the incipient recovery can develop into a long self-reinforcing process of growth and stability. The challenge is to turn that vision into reality.

OBSTACLES AND THREATS TO PROGRESS

Of course, there are obstacles to that vision; some need to be dealt with promptly, and some will need to be guarded against as we move ahead. The more firmly we move to deal with those threats—by action now and by setting ourselves clear guidelines for the future—the faster we can end the doubts and restore the confidence necessary to success.

THE FEDERAL DEFICIT

The most obvious obstacle that looms ahead is the prospect of huge Federal deficits even as the economy expands. I have spoken to the point on a number of occasions, and will soon be testifying before the Budget Committee.

Today, I will only summarize the problem in a few sentences, and I'm not even sure that it's necessary to do that after listening to your comments and those of the other Senators. I think the hopeful thing that remains here is the problem is so well understood. What remains is the need to take action. I know that's difficult and sensitive, but I do think that is a critically important matter to the success of our economic policy in the years ahead.

The bulk—but far from all—of our present $200 billion deficit reflects high unemployment and reduced income. At a time of recession and relatively low private credit demands, the adverse implications of the current deficit for interest rates and financial markets may be muted. But the hard fact is that the deficit, as things now stand, will remain in the same range, or rise further, as recovery proceeds and private Credit demands rise. In other words, the underlying imbalance between our spending programs and the revenue-generating capacity of the tax system at satisfactory levels of employment ("the structural deficit") promises to increase as fast as the "cyclical" deficit declines.

That prospect, essentially without precedent in the past, threatens a clash in the financial marketplace as huge deficits collide with the needs of business, home buyers and builders, farmers and others for credit. The implication is higher real interest rates than necessary or consistent with our investment needs in the future and expectations of that future "clash" feeds back on markets today. The adverse consequences are reinforced and aggravated by the widespread instinct in financial markets and among the public at large that such large deficits will feed inflation by creating pressures for excessive money creation or otherwise, leading to doubts about the success of the disinflationary effort.

That outlook and analysis is essentially agreed by the administration, the Congressional Budget Office, by citizen groups that have expressed alarm about the budgetary situation, and by independent budget analysts. It is that broad consensus on the nature of the problem that provides a base for the necessary action. What remains to be done is to take those actions. I fully realize the sensitivity and difficulties of the choices to be made. But I am also aware, as I am sure you are, that a great deal depends on a successful resolution of those efforts.

INTERNATIONAL ECONOMIC AND FINANCIAL SITUATION

The risks and uncertainties in the present situation are compounded by the fact that so much of the world is in recession, and adverse trends in one country feed back on another. For instance, falling exports have accounted directly for some 35 percent of the decline in our GNP during the recession; in past recession, in contrast, our exports have typically grown, cushioning other factors depressing production and employment. After earlier periods of exaggerated weakness, the great strength of the dollar in the ex-

change markets over the past 2 years contributed to the progress against inflation—but it also depressed our exports. We cannot build the stability of our economy on extreme exchange rate fluctuations.

Another dimension of the risk is the danger that nations will try to retreat within themselves, insulating their economies by protectionist measures. But, as we learned in the 1930's, such policies only aggravate the mutual difficulties. Another aspect is instability in foreign exchange markets.

But today, we face another more immediate threat in the international financial area. I will reserve detailed comment for my appearance before you tomorrow. Suffice it to say now that the potential for an international financial disturbance impairing the functioning of our domestic financial markets at a critical point in our recovery is real. I firmly believe the major borrowers and lenders, with the understanding and support of governments, central banks, and international institutions, can face up to and deal with those problems constructively. But the cooperative pattern we have seen emerge in managing these problems is absolutely dependent on the capacity of the International Monetary Fund to continue to play a key role at the center of the international financial system. Early congressional approval of the enlargement of IMF resources, agreed by the Interim Committee of the Fund last week, will be essential to that effort.

ATTITUDES TOWARD PRICING AND WAGE BEHAVIOR

I have already described the pricing restraint and the trend toward more moderate increases in wages that have developed in the midst of recession. As best as I can assess it, the mood today is consistent with maintaining that momentum. There is realization that competitors at home and abroad have large potential capacity, and after all the efforts to cut break-even points, expanding volume will itself produce satisfactory profits as well as larger employment opportunities. The smokestack industries, hit so hard in the period of recession while already faced with the need for structural change and with particularly high wages by domestic or international standards, have particularly strong incentives for caution.

But there is, of course, another possibility. Business and labor—habituated to inflation in the 1970's, highly sensitive to the failure to sustain past efforts to restore stability, and eager to restore past price or wage concessions—may be tempted to test their bargaining and pricing powers much more aggressively as orders and production expand. If they were to do so, sensitivities of consumers and financial markets to the possibility of reinflation would only be aggravated, tending to keep interest rates higher and greatly increasing the difficulty of maintaining the economy on a noninflationary path of growth.

This is an area where Government policy can greatly contribute, by resisting protectionist pressures externally, and by removing or relaxing obstacles to competition in product or labor markets. Areas of the economy that have seemed almost impervious to the disinflationary trend and market pressures—such as health care and higher education—seem to me to deserve special attention.

Through all those particulars, however, restraint in price and wage setting can reasonably be expected only if Government financial policy remains plainly oriented toward containing inflation. Without a sense of conviction on that score, the temptation to jump ahead of the pack—to anticipate the worst—as employment and orders are restored may become irresistable. The fact is both labor and business have much to gain from stability, and moderation in pricing and wages within a framework of financial discipline will be consistent with higher real wages, profits, and employment.

The skepticism that had been built up over many years about the resolve to deal with inflation has been reduced but not eliminated. There is little or no leeway at this stage for mistakes on the side of inflation. Policies designed with the best will in the world to stimulate, but perceived as inflationary, may, unfortunately, produce more inflation than stimulus.

MONETARY POLICY IN 1982

It is in that broad framework and context that monetary policy has been implemented in 1982 and that we in the Federal Reserve look ahead to 1983 and beyond. Our objective is easy to state in principle—to maintain progress toward price stability while providing the money and liquidity necessary to support economic growth. In practice, achieving the appropriate balance is difficult—and a full measure of success cannot be achieved by the tools of monetary policy alone. The year 1982 amply demonstrated some of the problems facing monetary policy during a period of economic and financial turbulence, and the need for judgment and a degree of flexibility in pursuing the objectives we set for ourselves.

As you know, policy with respect to the growth of money and credit has been rooted in the fundamental proposition that, over time, the inflationary process can only continue with excessive growth of money. Conversely, success in dealing with inflation requires appropriate restraint on growth of money and liquidity.

Those broad propositions must, of course, be reduced to specific policy prescriptions, and for some years the Federal Reserve had followed the practice, now required by the Humphrey-Hawkins Act, of quantifying its objectives in terms of growth ranges for certain measures of money and credit for the year ahead. In doing so, we have known that for significant periods of time the relationships between money and spending may be loose, that there are recurring cyclical patterns, and that the mix of real growth and inflation can and will be affected by factors beyond the control of monetary policy. But we also count on a certain predictability and stability in the relationships over time between the monetary and credit aggregates and the variables we really care about—output, employment, and prices.

In 1982, however, those relationships deviated substantially from the patterns characteristic of the earlier postwar period. The simplest reflection has been in movements of velocity—the relationship between measures of money and credit and the GNP. As shown on table I attached, the velocity of M_1, which had been tending higher throughout the postwar period, dropped at a rate of almost 4 percent over the past five quarters. The broader monetary

aggregates and broad credit aggregates as well also behaved typically in relation to the economy; that velocity dropped during the recession by larger amounts than usual. More sophisticated statistical techniques, taking account of lags, interest rates, and other variables, confirm the fact normal relationships did not hold in 1982.

In establishing its various target ranges at the start of 1982, the Federal Open Market Committee specifically noted that a number of factors, institutional and economic, would affect the relationship of monetary and credit growth to the GNP, and contemplated that M_1 in particular could deviate from expected patterns for a time in the event economic and financial uncertainties fostered desires for liquidity. In reporting to you in July of last year, I emphasized the committee was prepared to accept higher periods of M_1 growth for a time in circumstances in which it appeared precautious or liquidity motivations, during a period of economic uncertainty and imbalance, were leading to stronger-than-anticipated demands for money.

In the event, M_1, after moving close to and within the target range around mid-year, grew much more rapidly later, ending the year with growth of about 8½ percent, substantially higher than in 1981 and above the target range (see table II). Both M_2 and M_3 tended to rise through the year somewhat more rapidly than the targets contemplated, averaging in the final quarter about three-quarters of 1 percent above the upper end of the target range. (Revised "benchmark" data and some partially offsetting definitional changes since the end of the year have reduced the overshoot to about one-four to one-half percent.)

In the light of the clear indications that velocity was declining more rapidly than in earlier recession periods, the absence of recovery during 1982, and recurrent strains in financial markets, above target growth was accommodated in the conviction that policy, in practical effect, would otherwise have been appreciably more restrictive than intended in setting the targets. The rapid declines in interest rates during the second half of the year—encouraged in part by some actions to restrain the deficit and more broadly by growing realization of the degree of progress against inflation—were clearly welcome. Credit-sensitive sectors of the economy, as noted earlier, tended to strengthen. But after leveling off in the second and third quarters, economic activity dropped again in the final quarter in the face of heavy inventory liquidation. In all these circumstances, strong efforts to confine M_1 growth to the target range seemed clearly inappropriate, particularly with the broader aggregates running quite close to their ranges.

An important further consideration during the final quarter was that some of the monetary aggregates were greatly influenced by purely institutional factors. The maturity of a large volume of all-savers certificates in October temporarily led to large flows into transaction balances counted in M_1. Subsequently, highly aggressive marketing of new "money market deposit accounts" by banks and thrift institutions led to enormous inflows into the highly liquid instrument, which is classified within the M_2 aggregate.

In the first 7 weeks after the introduction of that account, which combines some characteristics of a transaction account with savings, more than $230 billion of money has flowed into the new in-

strument. The shift of financial resources is without precedent in amount and speed. While the great bulk of those funds simply reflected movements from lower interest accounts already included in M_2, a sizable fraction—estimates range to about 20 percent—was derived from large certificates of deposit or market instruments not included in that aggregate. The result has been a gross distortion of the growth of M_2 in December and, more importantly, in January.

No statistical or survey technique available to us can identify with precision the impact on M_2 of these shifts of funds. The available data do suggest, however, that—taking December and January together—the underlying growth in M_2 (that is, excluding shifts of funds formerly placed in non-M_2 sources) was not markedly different from the general range established earlier. In other words, the exceptionally strong growth of M_2 in January could most reasonably be treated as having no policy significance.

MONETARY POLICY IN 1983

In setting out our monetary and credit objectives for 1983, the Federal Reserve has had no choice but to take into account the fact that "normal" past relationships between money and the economy did not hold in 1982, and may be in the process of continuing change. Part of the problem lies in the ongoing process of deregulation and financial innovation that has resulted in a new array of deposit and financial instruments, some of which lie at the very border of "transactions" and "savings" accounts, defying clear statistical categories.

Perhaps more significant over longer periods of time, both economic and regulatory change may affect trend relationships. Both declinining rates of inflation and the growing availability of interest on transaction accounts at levels competitive to market rates could induce more holdings of cash relative to other assets over time. The payment of interest rates on transaction accounts could also affect the cyclical pattern of M_1. The broader aggregates, by their nature, should be less sensitive over time to innovation since they encompass a much broader range of assets, but the phased elimination of rigid ceiling interest rates has changed cyclical characteristics.

All of this has greatly complicated the job of setting targets for 1983. In setting the ranges, the committee believed that monetary growth during the year would need to be judged in the light of developments with respect to economic activity and prices, taking account of conditions in domestic credit markets and internationally.

At the same time, the FOMC is well aware that past cyclical expansions have typically been accompanied by sharp increases in velocity, particularly for the narrower aggregates. We assume that, to some degree, that pattern will emerge again. There is a strong presumption that the target ranges will not be exceeded or changed without persuasive evidence, as in 1982, that institutions or economic circumstances require such change to meet our more basic objectives.

As set out in the formal Humphrey-Hawkins report, members of the Federal Open Market Committee and other Reserve Bank

presidents participating in our discussions generally look toward moderate recovery in 1983 in a context of declining or stabilized inflationary pressures. While the individual forecasts vary over a considerable range, the majority anticipates real growth in the 3.5- to 4-percent area over the four quarters of 1983, fractionally higher than the administration forecast. Nearly all expect the GNP deflator to rise less rapidly than the 5.6 percent projected by the administration. Projections of nominal growth are mostly in the 8- to 9-percent area. In approaching its policy judgments, I believe the committee recognized the desirability of achieving and maintaining a lower level of interest rates to encorage growth, but felt that this could only be realistic in a context of building on the progress already made against inflation. Efforts to force interest rates down at the expense of excessive liquidity creation could not be successful for long.

Against all this background, the committee decided that, for the time being, it would place substantial weight on the broader aggregates, M_2 and M_3, in the belief that their performance relative to economic activity may be more predictable in the period ahead (see table III).

The target range for M_3, which is least affected by institutional change, was left at 6½ to 9½ percent, measured from the fourth quarter of 1982 to the fourth quarter of 1983.

The target for M_2 was set at 7 to 10 percent and the base was shifted to the February–March average of this year to minimize the institutional distortions. Our assumption is the flow of funds into M_2 from other savings media will have sharply subsided in coming weeks. However, the M_2 target range does take account of staff estimates that residual shifting will probably raise M_2 growth by 1 percent or a little more over the remainder of the year; abstracting from such anticipated shifts, the M_2 target, in practical effect, is the same or slightly lower than the target for 1982. Consistent with these targets, effective growth, that is, abstracting from the influence of shifts into new accounts, in both M_2 and M_3 is expected to be somewhat lower in 1983 than in 1982.

The M_1 target was widened and set at 4 to 8 percent. Less emphasis has been placed on the M_1 target in recent months because of institutional distortions and the apparent shift in the behavior of velocity. The degree of emphasis placed on M_1 as the year progresses will be dependent upon assessment of, and the predictability of, its behavior relative to other economic measures, and the range may subsequently be narrowed. Over the year, growth in the lower part of the range would be appropriate if velocity rises strongly, as has usually been the case during recoveries. An outcome near the upper end would be appropriate only if velocity does not rebound sharply from the declines last year, and tends to stabilize close to current levels. Only modest allowance has been made for the new Super NOW accounts drawing funds into M_1 from other sources, and the target would clearly have to be reassessed should the depository institutions deregulation committee permit depository institutions to pay market rates of interest on business accounts.

In addition, the committee set forth for the first time its expectations with respect to growth of total domestic nonfinancial debt,

and felt that a range of 8½ to 11½ percent would be appropriate. Data for such a broad credit aggregate are not yet available monthly, nor are the tools available to influence closely total flows of credit. While the credit range during this experimental period does not have the status of a target, the committee does intend to monitor developments with respect to credit closely for what assistance it can provide in judging appropriate responses to developments in the other aggregates. The range would encompass growth of credit roughly in line with nominal GNP in accordance with past trends; the upper part of the range would allow for growth a bit faster than nominal GNP in recognition of some analysis suggesting a moderate increase in the ratio of debt to GNP may develop during the year. Now I know, Mr. Chairman, all of these numbers and qualifications can create a bit of confusion, so let me put aside all the nuances that we use in the trade. In practical effect and taking account of institutional change, these new targets seem to me directly comparable to those we had last year and we intend to be within them. Money in its various definitions should grow less this year than last and, of course, we are operating in the context in which inflation is down, in which the economy is operating below its potential, and in these circumstances targets seem to me fully compatible with easier market conditions, lower interest rates during the year insofar as monetary policy is an influence. But, of course, other factors influence interest rates as well, including that deficit factor that we have discussed.

I appreciate the complexity—for the Federal Reserve and for those observing our operations—of weighing performance with respect to a number of monetary and credit targets, of taking account of institutional change, and of assessing the possibility of shifts in relationships established earlier in the postwar period—a possibility that can only be known with certainty long after the event. But we also can sense something of the dangers of proceeding as if the world in those respects had not changed.

I neither bewail nor applaud the circumstances that have put a greater premium on judgment and less automaticity in our operations; it is simply a fact of life. In making such judgments, the basic point remains that, over time, the growth of money and credit will need to be reduced to encourage a return to reasonable price stability. The targets set out are consistent with that intent.

I understand—indeed to a degree, I share—the longing of some to encompass the objectives for monetary policy in a simple fixed operating rule. The trouble is, right now, in the world in which we live, I know of no such simple rule that will also reliably bring the results we want.

The basic rule we must observe is that the sustained forward progress of the economy is dependent on a sense of price and financial stability—and without it, we will undercut the growth we all want. That objective, as I have emphasized, will require that we avoid excessive growth of money and credit because, sooner or later, that growth will be the enemy of the lower interest rates and stability we need.

I have given you our best judgment on the appropriate role for monetary policy in 1983. But, success in achieving our objectives is not in the hands of monetary policy alone—and we look forward to

all elements of policy moving ahead in pursuit of those common goals.

[Tables accompanying statement follow:]

TABLE I.—VELOCITY OF THE MONETARY AGGREGATES

	M_1	M_2	M_3
	Average annual rate of change in the velocity of—		
1950 to 1982	3.2	0.2	−0.2
1950's	4.2	[1] 1.5	[1] 1.5
1960's	3.0	−.2	−.5
1970's	3.3	.3	−.9
	Annual rate of change in velocity		
1980	2.1	.4	−.3
1981	4.3	.2	−1.9
1982	[2] (7.0) [3] 4.8	−5.4	−6.2

[1] Represents growth rates for the velocity of a money series measured as the sum of currency, M_1 deposits, and all savings and time deposits at banks and thrift institutions. Data are not available to break time deposits by size before 1959, so that there is not a basis for distinguishing between M_2 and M_3 in the early period.

[2] Figure in parentheses represents velocity after abstracting from shifts into newly authorized NOW accounts in that year.

[3] For the five quarters ended with QIV 1982, the velocity of M_1 declined by almost 4 percent at an annual rate. One has to go back nearly 30 years, to 1954, to find a year with a significant 5-quarter decline; the five quarters ending in mid-1954 showed a 2 percent annual rate of decrease in M_1 velocity. Other 5-quarter M_1 velocity declines in the period since 1950 were extremely small—only 0.3 of a percent in the five quarters ending in the QII 1958 and just 0.1 of a percent in the period ending with QIV 1970.

Note: Annual changes based on years measured from QIV to QIV.

TABLE II.—MONEY AND CREDIT RANGES AND ACTUAL GROWTH, 1982

[QIV 1982 over QIV 1981, except as noted]

	Range	Actual growth	
		After revision for benchmark and definitional changes	Before revision
M_1	2½–5½	8.5	8.3
M_2	6–9	[2] 9.2	9.8
M_3	6½–9½	[2] 10.1	10.3
Bank Credit [1]	6–9	7.1	7.1

[1] Base for range was the average for December 1981 and January 1982 to abstract from the distorting effects on bank credit of shifts of banks' loans and investments to the new International Banking Facilities, which had been authorized beginning in early December.

[2] The definitional changes were to exclude IRA-Keogh accounts from M_2 and M_3 and to include in those aggregates tax-exempt money market funds. These changes were made to maintain consistency in the treatment of similar financial assets—with IRA-Keogh accounts held in depository institutionals, like other IRA-Keogh's and regular pension funds, now excluded from monetary aggregates and with all money market funds, tax-exempt or not, now included in the aggregates. The exclusion of IRA-Keogh accounts lowered growth of M_2 and M_3 by about 1 percentage point. Inclusion of tax-exempt money market funds raised growth of these two aggregates by about ½ percentage point.

TABLE III.—Monetary and credit growth ranges for 1983 (QIV over QIV basis, except as noted)

M_1	[1] 4 to 8
M_2	[2] 7 to 10
M_3	6½ to 10½

Total credit [3]	8½ to 11½

[1] This range allows for a modest amount of shifts from sources outside M_1 into super-NOW accounts. Thus far, growth in those accounts has been relatively small. The range also assumes that authority to pay interest on transactions accounts is not extended beyond presently eligible accounts.

[2] Represents annual rate of growth from the average level of M_2 outstanding in February-March 1983 to QIV 1983. The February-March 1983 base was chosen, rather than QIV of 1982, so that growth of M_2 would be measured after the period of highly aggressive marketing of money market deposit accounts (MMDA's) has subsided. These accounts, introduced in mid-December, rose to over $230 billion by early February, with a substantial amount of funds transferred into them from sources outside M_2, such as market instruments and large CD's. The 7 to 10 percent range for M_2 allows for some residual shifting from market instruments and large CD's into MMDA's over the balance of the year.

[3] Represents domestic nonfinancial debt.

The CHAIRMAN. Thank you, Mr. Chairman.

Before we begin the questioning, may I once again respond to the question asked before the hearing started: That is why we didn't get a bigger hearing room. My response was it had not occurred to me frankly. It did occur to my staff and I have been informed since that they did attempt to get a larger hearing room. There were only two that were larger than this room and neither one of them were available. So, although it did not occur to me that we should have a bigger hearing room, I admit this is home and this is where the Banking Committee resides, the staff was brighter than I, which is not unusual in the Senate. They did anticipate that and were unable to find one.

In my opening statement I noted that Treasury bill rates were about what they were in late August and long-term Treasury yields are higher than they were in November and December. Could you explain for us the failure of interest rates to continue falling along with the decline in the inflation rate?

INTEREST RATES VERSUS INFLATION RATES

Mr. VOLCKER. Interest rates went down very sharply over the summer as you know. I think at that point there was a growing realization that the inflation rate had moved sharply lower and was likely to stay lower for a while, and there was a return in confidence in that respect that helped to propel interest rates lower. Markets tend to anticipate and they move very rapidly, and after moving by 5 or 6 percent below their highs in a very limited period of time, I think there was some feeling of pause—stop, look, listen, let's see what's happening.

The CHAIRMAN. But what's happened is: inflation continued to go down.

Mr. VOLCKER. I agree what's happened is the inflation figures continue to look good. There is also a kind of growing realization—after some satisfaction with the action that Congress took last summer with respect to the deficit— that you were still left with a huge deficit problem. Those numbers began to seep into consciousness more fully and clearly have had an effect on the market.

I also think, more recently, as signs of the economy turning have developed, that there has been a certain amount of skittishness, with people saying, well, that's fine; the economy is going to turn; but can we maintain this good inflation performance in an expanding economy? I think we can, but there is a certain amount of questioning about that in the market and a kind of catch-22 situation.

They see the economy beginning to recover and they say that's good, but what's that going to mean for inflation and what's that going to mean for financial markets down the road?

I don't think this is at all the unanimous feeling in the market, but some of them have looked at the monetary aggregates that you referred to and asked, "Does that reinforce my concern that after all this great progress on inflation some time down the road inflation is going to come back?" I think you cited a figure of M_2 growth of 13 percent over several months. You can only get a figure like that by including the January increase, which was enormous. I would just again make the point that I made in my statement, that I think that January figure in economic terms is not enormous at all. That is an institutional deviation because of the introduction of the new money market deposit accounts. Its economic significance is close to zero.

We cannot identify with absolute precision what impact MMDA's had on the figures but we don't have any particular reason to think that that January figure was indicative of a sudden change in the M_2 growth pattern, which in the last quarter has been running in the 9-percent area.

The CHAIRMAN. Mr. Chairman, you and I have discussed many times the psychological impacts on the market. We have also discussed the fact that over the years Presidents and Congress alike have promised a balanced budget. Every new President comes in and says he's going to balance it by the end of his term and so we can easily understand why the markets don't believe that. It never happens. We can understand why they are skittish now, why they worry about inflation being reignited.

INFLATION IMPACT ON SHORT-TERM RATES

The thing that I personally don't understand—I understand the impact on long-term interest rates because of that fear, but with all the good things that are being reported now on the inflation rate and—particularly the wholesale rate down so low, even negative in some months—I wish somebody—you or someone else—could explain to me why the inflationary expectations have an impact apparently on short-term rates.

Now if people want to be reasonable out there in the marketplace short-term rates, in my opinion—real short-term rates ought to be a lot lower. I can accept their explanation of, OK, long-term rates are going to stay up because we don't trust Congress and we don't trust the Fed and we don't trust anybody in the longer term. But I'm wondering if there isn't just some profiteering out there in short-term rates because inflation is not going to go up quickly, nobody thinks that it's going to go back up this year to any significant degree. Well, somebody wants a 90-day loan or an automobile loan of a couple years or so and nobody can answer that question for me. Maybe you can today as to what's the psychological bit—excuse, in my opinion, has got to do with the continued high level of real short-term interest rates.

Mr. VOLCKER. I think you're right that the fears about future inflation ought to logically have a bigger impact—and I think they do—on the long-term rates than the short-term rates.

The CHAIRMAN. A lot bigger impact.

Mr. VOLCKER. But the two rates are related and the market arbitrages back and forth between them. Let me say that as far as short-term rates are concerned, Treasury bill rates were down to 7.5 percent; they're more than 8 percent now. What do you think the inflation rate is now? On the face of it, I accept it as 4 percent or so. The Consumer Price Index shows that's been affected by——

The CHAIRMAN. And the automobile companies are bragging about advertising 11.9 percent. You've got a big spread there.

Mr. VOLCKER. You always have a big spread on consumer loan rates. That may be abnormally high now. If you take the Treasury bill rate, it's high, but it's not out of sight relative to what a lot of people think the inflation rate is. Beyond that, let me say that obviously in the short run the pressures on bank reserve positions which we influence, have an effect on short-term rates. We have had growth in the aggregates that I don't think have been inappropriate, but somewhat on the high side relative to our targets, and we have made allowance for the liquidity demands and all the rest.

But if we were to provide more reserves, which would have an influence presumably in the very short run on interest rates declining, we would get more growth in those aggregates; you expressed some concern about the rate of growth already. That's part of the problem with short-term rates.

The CHAIRMAN. Well, maybe there is not an answer to my question. It just still seems to me——

Mr. VOLCKER. If the suggestion is that we should push down short-term rates, you can only do that by getting more monetary growth, and it's a matter of our judgment as to how much monetary growth we want. You can't have it both ways.

The CHAIRMAN. As I say, apparently there's a much looser relationship between long-term rates and short-term rates and I just don't see—I can justify—not like, but understand—the inflationary expectations for long-term rates, mortgages and all of that. But the shorter term consumer rates and so on, I still think they are abnormally high and well above what they ought to be from the past experience I've had in looking at the economy.

Mr. VOLCKER. Consumer rates can be affected by these expectations. Take a car loan. It's typically for 3 to 4 years and at a fixed rate. In making that loan, a bank is going to anticipate how rates will behave over a considerable period of time. Apart from the cost and other normal rate relationships, I think you definitely do have the consideration in consumer loan rates of what the future interest rate pattern will be, and not just the pattern over the next 3 months.

The CHAIRMAN. There is an incredible difference, Mr. Chairman, from 2-, 3-, or 4-year loans and somebody risking a 30-year mortgage and tying up their money for that period of time.

Mr. VOLCKER. There is a difference between those two.

The CHAIRMAN. There's a great deal of predictability in that short time.

Mr. VOLCKER. I agree with that, but it's a matter of degree. It's not black and white.

The CHAIRMAN. I agree it's not black and white, but I think there's a lot more gray in between and we are not——

Mr. VOLCKER. Let me make that basic point: I agree that consumer loan rates have been slow to come down in line with market rates. But if you go back some years when you had normal relationships established over a period of time, there would be a very considerable margin between consumer loan rates and let's say, the Treasury bill rate; you would have consumer loan rates in the 10- and 12-percent area for years when the Treasury rate was in the high or medium single digits.

The CHAIRMAN. The reason I'm concentrating so much on short-term rates, because you know how I feel—the long-term rates I think can only be solved when Congress gets its act together. Those outyear deficits are so horrendous that you, as Chairman of the Fed, and the Open Market Committee can't do anything about the 1990 deficit and 1985 and those projections. I don't see how long-term rates can reasonably be expected to come down and stay down until the fiscal house is in order.

The short-term interest rates could have a dramatic impact on getting us out of this recession. Every time the auto industry offers 12, 9, 10.9, 11.9, it's even more helpful than rebates in selling automobiles and getting those automobile workers back to work. I think those short-term rates could really have an impact on whether we come out of this recession, whether the unemployment rates start to go down and therefore takes some pressures in relationship, however loose it may be, over the long-term rates as well because the impact there obviously as we put more people back to work and they pay taxes, those deficits start going down because of the recovery and then you have an impact. So I think short-term rates could help lead us to lower long-term rates as well.

Mr. VOLCKER. Let me just draw the policy conclusion from your comments. You say you would like to see short-term rates lower. Presumably the policy approach toward that would be for the Federal Reserve to put more money in the market. That's what we can do in concept to try to get short-term rates lower. The reflection of that will be in higher money growth than otherwise would take place, and what we have to balance is the concern that you expressed—too strongly, in my judgment, frankly—earlier that monetary growth is too rapid. I don't share that view, but obviously, as a matter of judgment, we have decided not to push it higher aggressively.

The CHAIRMAN. Well, I guess you misunderstand the point I'm trying to make. I am not and never have been and am not now an advocate of you dumping a lot of money into the economy. I would not do that. I don't want to reignite inflation. I don't want high interest rates as a result of that. I have never been one to use the Fed as a scapegoat.

Mr. VOLCKER. I understand that.

The CHAIRMAN. What I'm trying to say is within your current monetary targets that short-term interest rates are entirely too high and the answer I can't get from anyone is why. I think they are much too high considering the amount of money in the money supply, in the monetary aggregates at this time, and that's why I used the term profiteers—people out there taking advantage of this situation where some of them are doing very well. At the same time, from the new money market account, I'm hearing a com-

plaint from all those people that demanded of me that in our bill we've got to mandate this new account, that they are awash with money and they don't know what to do with it and they can't loan it fast enough. So if they are awash with money—the excuse before was they had a shortage of money and the interest rates were high. Now are they high because they are awash with money and they don't know where to loan it?

DISTINCTION BETWEEN TWO INTEREST RATES

Mr. VOLCKER. Let me try to clarify that if I can. Let me make a distinction between two interest rates, the Treasury bill or the open market rate and the consumer loan rate. As to the open market rate, I don't think profiteering is a relevant consideration; it's a highly competitive market and, as a matter of simple analysis, based upon some past relationships, you would say with this much money relative to the economy and inflation, those rates should be lower. But they're not. Why not? It leads us to believe that there has been more demand for liquidity than you would ordinarily expect, which is why we have been accommodating that demand to some degree.

If you shift over to the consumer loan rate, an administered rate, I think, as I said, that there has been caution in reducing those rates for a number of reasons: In part, cautions about whether they would go back up again; in part, I think, concern and nervousness at times in the banking system about the potential cost of credit losses, either domestically or internationally; I think, more recently concern over the possible costs, clearly in the short run of this new money market deposit account which has increased costs. It's an aggressive market; there's no doubt about that. It's not unnatural to be a little hesitant, I suppose, in reducing your lending rates in the face of all that.

At the same time, the MMDA has provided a lot of funds. You're absolutely right about that. Some banks are, as you say, awash with liquidity. I think in time—and I think there is some evidence it is happening now—that will get pushed out into the market and this sluggishness in the rate decline may be overcome. We do regular surveys of consumer lending rates, but the last regular survey we did was in November. There's one going on now but we don't have the results. My sense is that those rates have begun to come down faster.

The CHAIRMAN. Thank you, Mr. Chairman. My time is up and I apologize to Senator Proxmire for going over but they handed me the note that my time was up to Senator Proxmire. I couldn't see it.

Senator PROXMIRE. To follow up on what the Chairman has been saying, I don't think the Chairman has been indicating any dissatisfaction with the rate of increase in the money supply as much as the fact that you, as Chairman, have not done what Arthur Burns did, for example, which was to jawbone the bankers when he thought that the rates were sticky and too high and couldn't be justified. At least I don't think you have. I don't mean to be unfair to you. I suppose there are questions as to how effective Chairman Burns was, but he did at times say that he thought that the banks

were maintaining a rate higher than could be justified. Isn't that right?

Mr. VOLCKER. He was for a time operating in the context of—I can't remember the title——

Senator PROXMIRE. The Committee on Interest and Dividends.

Mr. VOLCKER. The Committee on Interest and Dividends; that was part of the general control program that was in effect at that time.

Senator PROXMIRE. But you have a bully pulpit here just like the President. When you talk the bankers really listen.

Mr. VOLCKER. Sometimes, yes; sometimes, no.

Senator PROXMIRE. I'm sure they listen all the time.

Mr. VOLCKER. I have indicated that these spreads have tended to be pretty wide, but I haven't attempted to lecture the banks; I think that's fair to say on that point. I'm not sure that would be productive during this period. I will be interested in seeing the statistics when we get them, but I do have some sense that consumer loan rates are falling now; maybe they are not falling as fast or as far as we would like, but I think the most recent movement has been in the right direction. I think it's important that we do not convey the sense that we think there is an easy answer, other than instilling greater confidence that the inflation improvement not only can continue but will show further progress.

Senator PROXMIRE. We do get hit so often with the argument that real interest rates are very, very high and if you compare the short-term inflation with the short-term rate of interest, there is a terrific discrepancy and it just stands out, as the chairman pointed out.

Mr. VOLCKER. That's true, if you compare interest rates. I think frankly, that is a price, that we have paid for a decade or more in which we undermined confidence that we would be successful in dealing with the inflation problem. I think that confidence is returning. I think the atmosphere is quite different from what it was 2 years ago in that respect, but I suspect expectations haven't caught up with what I think is the reality; we will only be able to tell 2 years from now.

IMPACT OF INCREASED MONEY SUPPLY

Senator PROXMIRE. Mr. Chairman, I thought the most significant statement you made is when you departed from your regular text and said that the money supply in all its definitions will increase, as I understood you to say, less this year than last year.

Mr. VOLCKER. That is what our targets would imply, yes.

Senator PROXMIRE. In previous appearances you argued that faster money growth might lower the interest rate in the very short term temporarily but that inflationary expectations would be raised and interest rates would go back up perhaps higher than before. That was your principal argument against talk about congressional efforts to require the Fed to target interest rates. Now let's examine that argument in the light of what actually happened in 1982.

The Fed was under strong pressure to be more accommodative. You had a very restrictive policy in the first 6 months of the year.

Then, beginning in July, you were more accommodative. M_1 grew extremely fast in the second half and yet interest rates, at least until November, dropped and dropped sharply. They seemed to stabilize in the last 2 or 3 months. But the results of that easier policy seemed to be that the interest rates came down.

Mr. VOLCKER. In looking at the actual figures, Senator, the broader aggregates show some fluctuations from quarter to quarter but tend to be running around the higher end of our range all year long; there wasn't much difference between the first half and the second half; there was a little bulge in the third quarter.

Senator PROXMIRE. If you look at interest yields on corporate AAA bonds, for example, and mortgage rates, they all dropped very little in the first half of the year and then they dropped sharply in July.

Mr. VOLCKER. I agree. I don't think you can trace that precisely to these changes in money. We had a bulge in M_1 in the first quarter and then it was much lower in the next quarter, continuing into the third quarter; in the last 4 or 5 months of the year it was much higher.

We had a bulge in the last quarter of 1982 and interest rates were low; we had had a bulge in the first quarter of 1982 and interest rates were high. That tells you some other things were going on at the same time these money supply numbers were changing. Obviously, the economy was declining late in the year. But I think part of the reason—and even more important when you get to the long-term rates, as Senator Garn suggested—was that, as the year wore on, the progress against inflation became much more convincing and the market was psychologically right for a decline in interest rates in the summer.

Senator PROXMIRE. Well, the figures show in the first 6 months of last year the money supply growth was 1.2 percent and the last 6 months it was 14.3 percent. That's pretty jarring. These are the St. Louis Federal Reserve figures. I've got them here. That's what they report.

Mr. VOLCKER. The only figures I have here are quarterly figures and the quarterly figures don't show that. You may be looking at figures for some particular week.

Senator PROXMIRE. No; that's for the period ending July 28, 1982, and then——

Mr. VOLCKER. That's a weekly figure I think. There was a drop for a couple weeks right in that period. The quarterly average figures were 10.5 in the first quarter, 3.2 in the second quarter, 6.1 in the third quarter, and 13.2 in the fourth quarter.

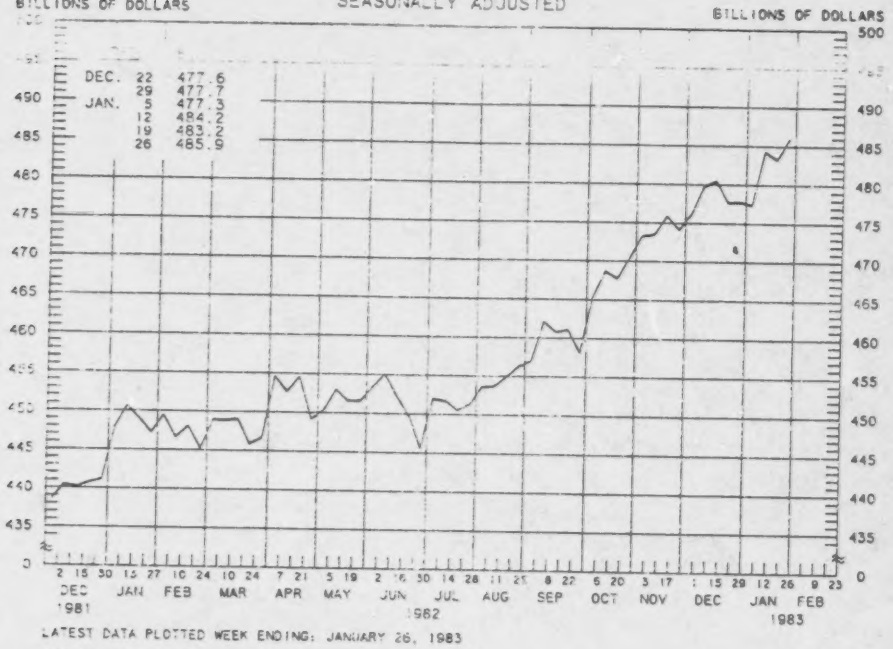
Senator PROXMIRE. Well, for the record, we'll give you the figures we have.

Mr. VOLCKER. All right.

[Chart follows:]

MONEY STOCK (M1)

AVERAGES OF DAILY FIGURES
SEASONALLY ADJUSTED



LATEST DATA PLOTTED WEEK ENDING: JANUARY 26, 1983

CURRENT DATA APPEAR IN THE BOARD OF GOVERNORS' H.6 RELEASE.

M1 CONSISTS OF CURRENCY HELD BY THE NONBANK PUBLIC PLUS COMMERCIAL BANK DEMAND DEPOSITS HELD BY THE NONBANK PUBLIC (EXCLUDING THOSE HELD BY FOREIGN BANKS AND OFFICIAL INSTITUTIONS) AND OTHER CHECKABLE DEPOSITS OF ALL DEPOSITORY INSTITUTIONS PLUS TRAVELERS' CHECKS.

MONEY STOCK (M1)

COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:

TO THE AVERAGE OF FOUR WEEKS ENDING:	1/27/82	4/28/82	6/23/82	7/28/82	8/25/82	9/29/82	10/27/82	11/24/82
6/23/82	2.2							
7/28/82	1.2	-1.1						
8/25/82	2.3	1.2	2.4					
9/29/82	3.9	4.1	6.6	12.2				
10/27/82	5.8	6.9	10.1	15.5	18.4			
11/24/82	6.9	8.3	11.6	16.2	18.4	20.8		
12/29/82	7.3	8.7	11.5	15.0	16.3	17.0	14.2	
1/26/83	7.6	8.9	11.4	14.3	15.3	15.5	13.2	10.9

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Senator PROXMIRE. Let me give you a scenario that is a nightmare for a lot of people. Assume that the recovery proceeds more or less in line with the 4 percent real growth you predicted for 1983. By the middle of the year inflation begins to pick up slightly and we begin putting more of our unused capacity back to work. Wall Street gets the jitters about inflation and in response the Fed exerts tighter control over the growth of the money supply, thereby choking off the recovery. Instead of a healthy 4- or 5-percent increase in real economic growth, we get an anemic 2- or 3-percent increase. You indicated this morning you expected a lower rate of money growth this year. Would this be a realistic scenario?

Mr. VOLCKER. I think it's a scenario some people worry about, but all I can say concerning that scenario and other scenarios is that the progress that we've made against inflation should continue. I really hope and expect it will be amplified during this period, that we will see a further downward trend, that this will take place in the midst of the kind of recovery you foresee. In those circumstances, the kinds of targets that I've set out would, in our judgment, be consistent with lower interest rates, if you look just at that variable.

Senator PROXMIRE. But some of our gains on inflation may be temporary windfalls and not sustainable. We've had a drop in commodity prices that has been severe. Food prices have stayed down.

Mr. VOLCKER. Right.

Senator PROXMIRE. And there's no indication it would seem that that's likely to continue.

PROGRESS AGAINST INFLATION GAINS MOMENTUM

Mr. VOLCKER. There is no doubt that we picked up windfall gains, if that's the right term, in the midst of a recession. But the point I tried to make in my statement is that I think we have done a lot more than that. I think we have put forces in place that have a certain momentum of their own, that can feed upon themselves, and that should continue to keep that inflation rate down and even improve it. The most important price trend or combination of price trends in the economy is that wage/productivity interaction. It is hard for me to put together a likely set of figures for 1983 that does not suggest moderation in wage costs, taking account of productivity.

I talked about labor costs accounting for the bulk of the value of what we produce. Another big element of cost in the economy is energy and oil. That looks like it's going to be on the favorable side; it's a question of how much on the favorable side, so long as we don't have war or some other political disturbance.

As I see it, in this basic unit labor cost outlook, in the energy outlook, we've got some very favorable signs for continuing the momentum against inflation. I don't think we can look for a lot of help in farm price declines. They're obviously low; but we have big surpluses there and that gives some protection on the upside. Against that, you asked about the likelihood that we will see some increase in commodity prices if we have recovery, because it's a natural part of recovery. Those amounts account for a very small portion of the total prices in the economy.

A bigger question over time is, I think, the exchange rate part of the equation, where we have benefited by the windfall gain—if that's the right term—from this enormous appreciation of the dollar in the past couple years. You certainly cannot look for another upward appreciation of the dollar of that sort. We have gotten some gains that are partly temporary from that side but, on the other hand, our analysis and I think most econometric analyses of this subject, suggest that the forces restraining prices from the exchange rate side tend to persist over a couple years. They're not sharply reversed in a period of a year or so.

While that will not be nearly as favorable as we look ahead, I don't think it's an area that, by itself, is going to threaten the more favorable outlook.

I think the chances are good for continuing downward momentum in the labor cost side of the economy. I could be wrong about that. If I'm wrong about that, our problems are much more serious. Historically, that has not been at all unusual in the first year of recovery. In fact, it would be the typical pattern. My concern in looking ahead is the danger that might arise in the second and third year of recovery. I think we ought to be focusing policy—and this has implications for monetary policy and for fiscal policy, too—such that the Government demonstrates that it really cares about inflation, that it's going to do its best, it's going to be successful in its financial policies in keeping down inflationary forces. I think that is the atmosphere in which we ought to be able to sustain this improvement on the labor cost side. Don't forget, that if we're right about productivity, then when I talk about a lower trend in wage costs, real wages would be rising, which is what the game is all about. You will get increases in real wages consistent with moderation in nominal wages. That's obviously what we would like to see. That's what we have to play for. That's what the aim is. We are not home free yet but we are a long ways, I think, in setting the stage for that kind of a recovery.

Senator PROXMIRE. Mr. Chairman, my time is up, but may I ask unanimous consent to have the chairman answer questions from Senator Cranston who had to depart?

The CHAIRMAN. Certainly, and there are other Senators who cannot be here who wish to have the same privilege, so we will submit questions to you for your response in writing.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

IMPROVEMENT IN PRODUCTIVITY

Chairman Volcker, one of the things you said in your remarks was that you were very pleased by the improvement in productivity. Doesn't improvements in productivity, the kind that we have experienced, mean that we have been closing inefficient plants and that the workers whose jobs have been sacrificed are unlikely to get them back?

Mr. VOLCKER. I think there's been some closing of relatively inefficient plants. That would be natural in a recession. But I think there have also been efforts both by labor and management to change work rules and to cut overhead, which tends to get swollen

during an inflationary and more prosperous period, and I think some of that can last.

One would rather, I suppose, see inefficient plants close than new investments in them. There is, in the short run, better productivity that way. If you assume a 4-percent rate of growth in the economy, then productivity is higher in the short run. It's true that creates a lag in getting employment to go up.

Senator HEINZ. But aren't you, in your statement suggesting that industries like the steel industry and the auto industry are really not going to see their plants reopen if those improvements in productivity are going to be maintained?

Mr. VOLCKER. No. Over time, clearly, they have to make improvements in productivity so that they can have the profits and the markets that are necessary to support those plants. In the very short run—I'm talking about a year or two—a rapid increase in productivity will reduce the amount of reemployment during that recovery period, all else being equal. But I don't think we can say we don't want gains in productivity for that reason, because the long-term future of the industry rests upon those gains.

Senator HEINZ. Let's pursue that a little further. You quite correctly single out the chances of rising protectionist pressures in this country and you're right. There's a tremendous amount of protectionist pressure in the countryside at large and in the Congress and I'm thinking, for example, if the Japanese do not follow through on the variety of promises they have made both recently and, frankly, in the past—you're likely to see legislation such as the local content bill, pass not just the House but the Senate. It probably won't fare too well down at the other end of Pennsylvania Avenue, but I think that's a measure of the spirit of the country.

One of the reasons that I asked you the question about productivity and I note the protectionist pressures is that virtually every country in the world—Japan, Western Europe, West Germany, France, England, Italy—all the developed countries have an adjustment policy for industries. Sometimes it works. Sometimes it doesn't. Sometimes it's backwardlooking. Sometimes it's forwardlooking. The Japanese are the most forwardlooking and the Germans next. For better or worse, the EEC has been trying to rationalize their policy.

In this country there is absolutely no commitment on the part of our Government or as far as I can tell on the part of Congress to a meaningful adjustment program. Would you agree?

Mr. VOLCKER. I think our presumption is that the Government isn't going to try to outsmart business. You're in an area where I don't have particular expertise, but I sense that Germany does not have a specifically thought-out reallocation process in these areas where Government brings to bear a strong influence on employment.

Senator HEINZ. At some risk of correcting you, they do, because of the Common Market Committee such as the coal and steel community, such as the special commission they have on steel directly.

Mr. VOLCKER. They can involve themselves.

Senator HEINZ. And on paper some of the things they do look pretty good.

Let me move to probably the major concern I think many of us have. You have mentioned it yourself. You skipped over it because it is obvious. It's the Federal budget. Let me ask you the bottom line.

If Congress does everything that President Reagan has asked it to do, is that going to bring down the budget deficit enough first; and second, is it going to bring it down enough so that real interest rates, instead of apparently on the long term picking up as they are right now, will go down?

Mr. VOLCKER. As a matter of general judgment, the dimensions of the program that the President has suggested in the outyears looks reasonable to me and in proportion to the size of the job. The only thing I'd say about that is I would like to see some of it phased in earlier.

Senator HEINZ. You're talking about the proposed increased taxes?

Mr. VOLCKER. The combination of measures that he has proposed. I'm just looking at the bottom line of fiscal effect, the effect on the deficit with those measures. I haven't got anything particular to say about the composition of those measures.

Senator HEINZ. I'm going to ask you about the composition.

Mr. VOLCKER. Let me not comment about the composition right now. Just looking at the sheer budgetary impact, I think it's in the right proportions. I'd like to see it come a little earlier.

Senator HEINZ. Do you think the President's program that maintains having a deficit close to or above 5 percent of GNP for the next 2 to 3 years is in fact an acceptable level for the deficit?

Mr. VOLCKER. When you say within the next 2 or 3 years. I get to the point of liking to see an impact a year earlier or so.

CUT SPENDING OR RAISE TAXES

Senator HEINZ. Let's talk about how we can do it. There are two ways we can do it—cut spending or raise taxes. Which do you prefer on top of what the President proposed?

Mr. VOLCKER. It doesn't have to be on top. We're talking about the timing.

Senator HEINZ. Well, to you it's timing. To the people out there, it's a cut in spending or an increase in taxes. Which do you prefer?

Mr. VOLCKER. I think his proposal is of the right general proportions.

Senator HEINZ. Which do you want us to accelerate, spending cuts or tax increases?

Mr. VOLCKER. From the general economic standpoint—from the standpoint of what increases the prospects for economic growth, productivity, investment, and all the rest—I would prefer to see as much as possible on the spending side.

Senator HEINZ. All right. Let's talk about where we can cut it.

Mr. VOLCKER. You're getting into your business rather than mine.

Senator HEINZ. Let me give you a for instance. Secretary Weinberger says that the defense budget is going to create a lot of jobs; the last thing we should do is fool around with the defense budget

because this is the principal means to create jobs. Do you agree with that?

Mr. VOLCKER. I would not look at the defense budget as a principal means to create jobs. I look at the defense budget as something for national security. That is the kind of consideration you have to balance: The needs for national security against the needs for social security. I haven't got anything in particular to suggest to you on those grounds. Those are very hard decisions, but they are not in my domain.

Senator HEINZ. Now you guessed it. Now let's talk about the tax side for a moment. The fact of the matter is that anything we do, as demonstrated by the social security reforms proposed, probably are going to be, as we say around here, a balanced package, which is to say it's going to be some of one thing and some of another. To the extent there are increases in taxes that are going to accompany any cuts in spending, beyond those proposed by the President, we have some choices. We can increase taxes on income. Everybody is talking about the third year indexing. We can increase taxes on consumption. The President has proposed, as you know, a $5 per barrel tax on oil. Or we can put taxes on jobs, savings, and investments. If you had to choose between those three categories which I've loosely lumped together, where should we increase taxes if we have to increase taxes; not that anybody wants to?

Mr. VOLCKER. I would try to put the emphasis on measures that have the least effect on incentives for savings and investment.

Senator HEINZ. All right. So taxes on jobs, payroll taxes, cutting back on depreciation allowances, or things that affect savings you would try and stay away from. I think most of us would agree with you on that.

That leaves us a choice between taxes on consumption and taxes on income.

Mr. VOLCKER. In some versions those come very close to the same thing. It depends on how you put the taxes on income.

Senator HEINZ. You're saying that really there's not much to choose from between those two?

Mr. VOLCKER. There are a lot of other considerations here, too, of course, considerations of equity and balance in the tax code. As a general proposition I——

Senator HEINZ. But from the standpoint of achieving economic growth, you find those are fairly similar?

Mr. VOLCKER. That's right, but there are other considerations you obviously have to deal with. From an economic standpoint, I think there's a lot to be said for moving the tax structure toward taxing income or consumption very broadly and cutting down on some of the special exemptions and deductions. That's not a very fresh thought, but I think it makes sense.

Senator HEINZ. We made a start on that in the Finance Committee last year.

Now the reason I've asked you these questions about the budget—and you have been very forthright in saying we really do need to do more than even the President anticipates——

Mr. VOLCKER. Earlier.

Senator HEINZ. To move faster, to move more definitively, I think you would probably agree, is that there's a lot of fear I think

reflected in the movement of interest rates that you may, as you've said today, be planning to hold the growth of the monetary aggregates within ranges below that of last year, but I think there's a fear not so much of what you're going to do in 1983 but what you're going to do in 1984. People remember in 1971 and 1972 Arthur Burns, who many people somehow remember as a high priest of fiscal conservatism—certainly that's what he preached to the Congress—in fact followed policies in 1971 and 1972 where, for a variety of reasons, the amount of money available to the economy actually increased dramatically.

How can we rest assured that notwithstanding what you say you're going to do in 1983 you're not going to abandon it in 1984?

Mr. VOLCKER. I'm not going to have a perfect answer for that question except by casting a lamp on experience, I suppose; one has to make his own judgment. I could not be more concerned about and sensitive to—and I think the Federal Reserve generally shares this—defending the progress we have made on inflation and supplementing that further. I don't know how I can give you a mechanical law that forecasts the future and gives you the assurance you want. I can only give you our conviction that after having gone through all the pain that we've gone through, and having seen the signs of progress that we see on inflation, we don't want to give it up.

FOLLOWING A MORE RESTRICTIVE MONETARY POLICY

Senator HEINZ. Well, my time has expired, but maybe I could just get a sense of this. Are you saying that in 1984, as you have said very correctly for 1983, you're going to follow a more restrictive policy than you followed in 1982?

Mr. VOLCKER. You're interpreting restrictive in terms of the growth in money supply as "restrictive"?

Senator HEINZ. Yes.

Mr. VOLCKER. The committee hasn't discussed this. As I personally would look at this, with the kind of economy that I would foresee, particularly the progress on inflation that I would foresee, I think it would be logical that the money supply would grow less rapidly in 1984 than in 1983—as nearly as one can see now.

But take an institutional situation. Suppose interest is paid on demand deposits across the board at market rates. You've then changed the institutional setting, and that could affect the appropriate rate of monetary growth.

You say more "restrictive" policy. It's more restrictive in terms of the money supply. It's not at all inconsistent with lower interest rates when you have an economy with less inflation over that period of time. It would be perfectly consistent with lower interest rates.

Senator HEINZ. Thank you very much.

The Chairman. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I want to start with a very narrow question and then work out from there. I'd just like your best judgment on this issue.

If today's interest rates essentially stay where they are for the next 3 to 6 months, will that enable us to have a strong and sustained economic recovery in your view?

Mr. VOLCKER. I don't think I can say it's necessarily inconsistent at all. It depends, obviously, upon a lot of other things, but we have seen, for instance, a very sizable rise in housing in recent months from very low levels at these interest rates or higher interest rates. I suspect—although I can't prove this because evidence is anecdotal—that we are seeing right now declines in consumer borrowing rates, even while some of these sensitive market rates are rising a little bit. I can't sit here and say that these rates are inconsistent with the kind of recovery you would like to see. I don't know that for sure. Only time will tell. I would feel more comfortable overall if interest rates were lower, but I've got to look at all those things in making that judgment.

Senator RIEGLE. If I understand what you're saying, you're saying that if interest rates stay at current levels that you think that a strong and sustained recovery can take place?

Mr. VOLCKER. I think that's possible, yes, but——

Senator RIEGLE. Do you think it's likely?

Mr. VOLCKER. I think your question was in terms of the next few months. Expand your time horizon to a couple years. Let me assume that inflation continues to improve as I hope. In that context, just guessing, I would think that environment would be conducive to lower interest rates; indeed, I think those lower interest rates might be very important in sustaining the rise that we're seeing in homebuilding. We haven't got a rise in business investment yet; we're going to have to see a rise in business investment. During that kind of a time period, with that kind of inflation outlook, it would both be very important and quite a natural expectation that interest rates would decline.

Senator RIEGLE. Well, I don't want to diminish the importance of the long-term outlook, however, most people that I talk to seem to feel that what happens in the next 6 months here from this day forward is really the critical period for several reasons.

One, we have been in a long, deep recession. There's been a lot of stress applied to the system. There's a lot of damage that's been done. You've got an international financial problem of some very considerable dimension as you well know. And the feeling that I get is that we need to get a recovery going now that we can depend upon, that in fact it happens, and that it gains speed as we go out over the next 3 to 6 months. And what I hear you saying is that you think interest rates at current levels will let that happen and that your expectation is that we will see things pick up steam here if interest rates stay where they are without in fact going up.

Mr. VOLCKER. I'm not predicting the level of interest rates.

Senator RIEGLE. I'm not asking you to predict them. I'm saying if they stay here, will that give us recovery?

Mr. VOLCKER. I think that is quite possible. I said that if you're interested in recovery—and we're all interested in recovery—the lower the interest rates, the more assurance you have about that. That doesn't lead you to a direct conclusion that you should do what you can to get interest rates down over that period because you've got a risk on the other side.

LOWER INTEREST RATES FOR SUSTAINTED RECOVERY

With respect to that judgment, I'm hearing a lot of opinion from professional finance people that interest rates in fact will have to go somewhat lower than they presently are for a strong and sustained recovery to take place, and that they would say that if rates have leveled out now and if we have hit an interest rate floor at the current level that that is not sufficient to get that job done. You've not expressed that view, but I'm reporting to you that's a view that I'm hearing with increasing frequency from others, and I must say I share that view.

If you look, for example, at what the Fed did last year with lowering the discount rate, because that's one specific step that you can take which is a judgmental step, and you lowered the discount rate in a series of steps and the rest of the rates came along and followed in a parallel pattern, but then that set of moves stopped and it gave the impression that perhaps the Fed thought that interest rates had come as low as they need to come at this stage of the game in order for recovery to take hold and to begin.

Now we see rates edging up again. If you take the new Treasury bill rates on January 17 they were 7.6; on the 24th, up to 8 percent; the 31st of January, up to 8.1; February 7, 8.2; February 14, 8.3 and rising. So we have seen an uptake in interest rates.

If your judgment is that interest rates at current levels are sufficient to kick off a recovery of some strength and there's a large body of opinion of others who feel in fact these rates are still too high and they need to be lower—then we've got a very tough contradiction here that has to be resolved, and that's why I really want to understand precisely your own thinking.

Mr. VOLCKER. I know that some people express that view and that's one side of the story, but let me use the same facts about last year and let me describe them a little differently.

REDUCING THE DISCOUNT RATE

We were certainly reducing the discount rate on seven occasions in the second half of last year. We were reducing it, generally, in line with the reductions in market rates. I don't think those discount rate reductions were generally leading the market, but we had no desire to impair a decline in interest rates during that period.

The last change we made in the discount rate was rather interesting. If any of them led the market, there was some interpretation that that one might be leading the market, but interest rates didn't go down. We reduced the discount rate and market rates were going kind of irregularly—we're talking about fairly narrow movements here—but interest rates today are higher than when we reduced the discount rate. That may tell you something about our ability to influence interest rates for any period of time through the discount rate.

If you just were looking at the recovery in the short run, obviously, the lower interest rates are, the more assurance you have of recovery. But, at the same time, we have to look at what's going on in monetary growth, what's going on with respect to inflation—which is good at the moment—what's going on in terms of the con-

viction and the assurance people have that inflation will stay down. And when we balance all those factors, then we have to make a judgment about the discount rate. I'll just have to let our actions speak for themselves in that respect.

The only point I make is that we have to balance the considerations that you rightfully put on the table and that we would put on the table and try to look as far ahead as we can to see what the ultimate effects will be.

Senator RIEGLE. Well, that's understandable. The problem is, as I read your statement and as you have delivered it, there's a clear inflation-fighting tilt to it. You really hit that bell over and over again and we all want to fight inflation, but I don't detect any kind of equal sensitivity in terms of the need for recovery.

Mr. VOLCKER. I——

Senator RIEGLE. Now if I just could finish, I'm not saying that you don't have that concern. I'm just saying the flavor of your document leans much more heavily on the inflation-fighting theme than it does on the economic recovery theme and that concerns me because I think at this point we need a recovery and we can get one without setting off some great spurt in inflation.

Mr. VOLCKER. Let me explain lest there be some misunderstanding. I put a lot of emphasis on this issue of inflation because I think it is important. What I tried to say in the statement is that I think it's important in itself, but it is important precisely in the terms you put the question, in terms of sustaining this recovery. I think we have a great opportunity for this recovery to extend years ahead, and I think in all probability that's going to take lower interest rates. I think the way to get there is by maximum assurance that we are not going to lose this progress that we've made on inflation. You have to get the lower interest rates and sustain the lower interest rates that you want, and that I see, in this environment, as being healthy, probable, necessary.

Senator RIEGLE. Well, it would be very valuable if we could continue right now but my time is up. I hope we will get a second round a little later.

The CHAIRMAN. Thank you, Senator Riegle.

Before I turn to the next questioner, I would explain particularly for the benefit of the new members of the committee the procedure that we have used in questioning, and it relates back to 1975 when I sat over where Senator Trible sits and I would come and sit for the entire hearing and senior Senators would waltz in for a minute or two and about 3 or 4 hours later, after having been there the whole time, I would finally get to question. So when I became chairman and Senator Riegle ranking minority member, we talked about changing that procedure and have followed an early bird rule where, regardless of seniority, those who have arrived early and are patiently sitting here, get to question first.

So with that explanation to my colleagues, particularly the new ones, Senator Hecht, you're next, regardless of the fact that you're sitting way, way over there.

Senator HECHT. Thank you very much.

Mr. Volcker, how can businessmen expand to create tax revenues when the profit margin is not there with present interest rates?

EXPANDING PROFIT MARGINS

Mr. VOLCKER. I think the major thing that will determine their profit margins and their profitability is the recovery that we have been talking about and expanding volume. As that recovery gets underway for a while, I would be hopeful that business investment will begin turning up. But business investment is going to be declining for a while, I'm afraid, because there's a certain momentum in that present situation. For the months immediately ahead I suspect you're going to see further declines in business investment.

The interest rates interact with many other factors. I think we can go back to the discussion with Senator Riegle. As I've indicated, in a noninflationary economy, I think lower interest rates will be desirable and necessary to sustain that increase in investment.

Senator HECHT. But as a businessman the profit margins are not there. Let's talk about prime rate, 11 percent. Obviously, the average small businessman is borrowing at two or three over prime plus perhaps one or two points along the way. There just is not any incentive to go out and expand.

Mr. VOLCKER. There's not an incentive now for a variety of reasons, but I accept the point that we'd like to see interest rates lower over time; there's no argument about that. The question is how you get them there and how you sustain them.

Senator HECHT. But to follow up on that, how can we increase our tax revenues for the Treasury if business does not expand?

Mr. VOLCKER. You need an expansion in the total economy to help increase revenue. Let me say that with any conceivable expansion in the economy over the next few years you're still going to be left with a big deficit in the budget unless some other action is taken.

Senator HECHT. No further questions.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Chairman Volcker, you have suggested in your testimony today that you believe that we are in a process of recuperation so far as the economy is concerned. In your appearance here last year you inferred that things were getting better, yet unemployment rates are much higher than you suggested then. Though you predicted some nominal growth, there was a 1.2 percent drop in GNP last year, I would share the concern of some members here that interest rates have still not come down far enough. If you recall in our questioning at this time last year, I asked you whether you weren't suggesting more of the same as you had with reference to the prior year when you suggested the 2.5 to 5.5 percent growth in M_1 and the facts indicate that during the course of the year you improved on that.

Mr. VOLCKER. Not everybody thinks it's an improvement.

Senator DIXON. Certainly the interest rates responded to what you did. You had a growth at a rate of 2.5 to 5.5 percent in M_1. Your actual growth was 8.5 percent.

Mr. VOLCKER. That's correct.

Senator DIXON. You had 6 to 9 in M_2. Your actual rate was 9.7. You had 6.5 to 9.5 in M_3 and your actual rate was 10.3.

Mr. VOLCKER. Correct.

Senator DIXON. Now while not much happened in the first part of the year, I think it's clear that after July you have pursued a less restrictive monetary policy in the second half of the year and market interest rates also fell correspondingly during the second half of last year.

Now don't you believe that the second phenomenon is a direct result of the first?

Mr. VOLCKER. Not entirely, no. I think a lot of other factors were at work in the market. If you take those broader aggregates, in general terms you will find a growth in the second half of the year pretty close to what it was in the first half of the year. If you just look analytically at those aggregates, something else must have been going on. A lot of other things were going on, also progress on inflation, but including obviously the fact that the economy relapsed back into recession after there was a lot of leveling off in the spring and summer and quite a lot of anticipation that recovery would take place at that time.

Those expectations were disappointed and the fallibility of economic forecasting has been demonstrated once again in 1982.

Senator DIXON. Mr. Chairman, I think we all agree that there are a lot of factors that enter into what comes about as a final result, but I think it is clear that in connection with all your monetary targets you were substantially above the high side of those monetary targets. You indicated earlier you don't recall how many times you dropped the discount rate. I believe you dropped it five times. It was 12 percent in June and 8.5 percent at the end of the year. So you couple the fact that your growth in every one of the areas M_1, M_2, and M_3, was substantially over the high side, and you dropped the discount rate five times. And I would suggest all of those things married together in the second half of last year had a substantial impact on the reduction in interest rates.

Mr. VOLCKER. We did not press to get those numbers within the target range. I think that accommodative view, if you want to call it that, was consistent with the interest rates declining but I do think there are other factors. You could have looked at midyear and seen that both M_2 and M_3 were above their targets if I recall the numbers correctly. In fact, they were probably about as much above the target in midyear as they were at the end of the year. That went along more or less as it had been.

There were other factors. We did let M_1 increase more rapidly—there's no doubt about that—in the first quarter when interest rates didn't decline.

Senator DIXON. I notice you're increasing your targets this year. M_1 would be increased from 4 to 8 percent; is that correct?

Mr. VOLCKER. Yes.

Senator DIXON. And M_2 7 to 10 percent, and M_3 6.5 to 9.5 percent.

Mr. VOLCKER. The M_3 target is the same. Let me just put an important footnote on the M_2. The increase in the M_3 target range reflects an institutional fact, a projection, which is subject to review, that simply because of the introduction of this new account, M_2 will run about 1 percent higher than it did last year. That's not of economic significance, so I think in a sense that target is the same as it was last year.

Senator DIXON. May I say I'm not being critical.

Mr. VOLCKER. No. I just didn't want any misunderstanding.

Senator DIXON. I would hope you would increase every one of the three targets this year.

Mr. VOLCKER. I don't think it's a real increase in the case of M_2. I'm not suggesting ——

Senator DIXON. It's a one-half of 1 percent. That's arguable as to whether that's a real increase. You've gone from 6 to 9 to 6.5 to 9.5, according to your testimony.

Mr. VOLCKER. Let the testimony explains why. Let me make a point that I made in the testimony. The same target, with a lower inflation rate, all other things equal—which they never are—means less pressure on the money markets.

Senator DIXON. I would only suggest to you, Mr. Chairman, predicated upon the experience of last year, that an increase in the target on all three levels—M_1, M_2, and M_3—and a reconsideration of possible further lowering of the discount rate, all of which worked well in my view in the last half of last year would be better medicine to consider for this year.

Mr. VOLCKER. We keep these things under review all the time and we will continue to do so.

The Chairman. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

REASONS FOR INTEREST RATE DROP

Mr. Volcker, what percent do you think of the interest rate drop was due to either poor economic conditions, your policies, or to the deficit?

Mr. VOLCKER. I'm inclined to say all of the above.

Senator MATTINGLY. Well, that's right, but when you factor them out?

Mr. VOLCKER. Most important things, by the middle of the year was that the progress on inflation had become convincing. There was still doubt, still questions about how long it will continue, but I think the atmosphere has changed a lot from what it was.

Senator MATTINGLY. Was progress on inflation by the economy getting weaker or by what we did here in the Congress or by what you did?

Mr. VOLCKER. I would like to say by what you did in the Congress, I think the fact that you passed that budget bill last summer—if that's what you're thinking of—was a factor at the time in tipping the psychology toward lower interest rates.

Senator MATTINGLY. In other words, you say the tax increase had an impact?

Mr. VOLCKER. Right.

Senator MATTINGLY. I'm sort of in disagreement on that. I think last year we were looking at a $90 billion deficit in our country so we came along and had a $99 billion tax bill and came on later with another $14 billion tax bill and we got a $200-plus billion deficit.

Mr. VOLCKER. I don't agree with that. I think the deficit was underestimated last year, but I think you would be worse off if you hadn't taken action.

Senator MATTINGLY. It's underestimated every year.

Mr. VOLCKER. It's underestimated maybe more frequently than it's overestimated.

Senator MATTINGLY. To follow what Senator Heinz was talking about about taxes and spending and not trying to pin anybody down about where we ought to be going to and what Senator Hecht maybe commented on and you didn't hold much hope out for what he was saying and you were talking about some taxes, tell me how that $99 billion tax bill—did the 10 percent withholding or the pension reform encourage savings and investment? Was it a stimulative thing, those two?

Mr. VOLCKER. I think the totai package ——

Senator MATTINGLY. I'm just asking you about those two.

Mr. VOLCKER. I can't make choices about the composition of the package. I expressed that generally to Senator Heinz. I don't want to get deeply into the composition.

Senator MATTINGLY. Do you think that's going to help you?

Mr. VOLCKER. I think if you're talking about interest rates, within broad limits, anything that reduces future deficits is going to be helpful.

Senator MATTINGLY. Does a withholding tax encourage people to put money into savings which really helps the markets?

Mr. VOLCKER. I'm not sure that withholding tax will have much of an impact on that. I suppose you would say to the extent it affects it at all, it's going to be negative.

Senator MATTINGLY. What brand new tax do you think of that could be really stimulative for our economy?

Mr. VOLCKER. Nobody is suggesting you do anything in terms of proposing the tax right now in January or February or in the months immediately ahead. What we are talking about are those deficits out there 2 or 3 years ahead, and I do think that action—including, if it comes to that, increasing taxes—to close that structural deficit will have a stimulating effect on the economy today because it will help interest rates today.

Senator MATTINGLY. Do you think a trigger tax—we're talking about a trigger tax in 1986 and it's probably a little gray as to what that means—is that going to be stimulative to the private sector? Is that going to encourage the private sector?

Mr. VOLCKER. I think if it were credible to the private sector that it was really going to take place, yes.

Senator MATTINGLY. Do you consider it credible, the proposal?

Mr. VOLCKER. I think it's one way of approaching it. I suppose, given the budget figures, I'd rather see it a little earlier.

Senator MATTINGLY. Which gets back to a sustained recovery. We all want a permanent recovery.

Mr. VOLCKER. Right.

Senator MATTINGLY. And you referred to a hope in the outyears, which I do too, but you say what's been proposed is reasonable and I say what's been proposed is unreliable. In the budget process, anything that gets past the first year has not really been reliable, at least in my association with the Federal Government for 7 years. Would you agree with that?

Mr. VOLCKER. I think you have put your finger on a problem. How do you make a change out there in the future convincing. I

think you've got to worry about that and think about that in any action you take.

Senator MATTINGLY. Which gets us to the—what impact will this $200 billion plus deficit this year or the proposed $189 billion in fiscal year 1984 have on interest rates?

Mr. VOLCKER. They would be higher than they otherwise would be.

Senator MATTINGLY. Therefore, let me narrow you down to a specific. How much confidence would be created as far as the Federal Reserve and everybody that sets interest rates if the budget were frozen? I'm not asking you to decide where it's frozen. I'm saying if we're going to spend $805 billion this year and we proposed spending $848 billion in 1984, what if we only spent $805 billion in fiscal year 1984? What impact would that have on interest rates?

Mr. VOLCKER. I think it would have a constructive impact.

Senator MATTINGLY. How much impact? What do you figure in points?

Mr. VOLCKER. I'm not going to——

Senator MATTINGLY. How much confidence? It would be a lot of confidence?

Mr. VOLCKER. If people thought you would carry through on that; yes.

Senator MATTINGLY. What would happen if you did that for 2 years?

Mr. VOLCKER. More confidence. We're not talking about the practicality of it now.

Senator MATTINGLY. It really would have more impact than an outyear discouraging tax increase then, right?

Mr. VOLCKER. Probably, but you're going to get——

Senator MATTINGLY. Probably or really? It really would, wouldn't it?

Mr. VOLCKER. Let me make a distinction between two things. I'm not trying to be overly subtle. In terms of new impact on the deficit, they would have similar impact on the deficit and on interest rates today. If you're looking also at structural considerations, lasting considerations, the spending cut would be better than the tax increase or investment considerations over a period of time. I agree with that; the spending cut would be healthier than the tax increase.

Senator MATTINGLY. Having been around this town longer than I have, if you froze an agency budget it would force them to reform the agency's budget?

Mr. VOLCKER. In some cases. I ask that question of my staff.

Senator MATTINGLY. But it is definitely an attention getter and probably would happen, isn't that correct?

Mr. VOLCKER. Yes; but you know as well as I do that you get into all kind of difficulties in freezing things.

Senator MATTINGLY. Yet, we have the private sector out there frozen, like Senator Hecht was talking about, where a man cannot make a decision.

Mr. VOLCKER. I don't want to disagree with you that moving on the expenditure side is more favorable.

Senator MATTINGLY. I would take your comments as acceptance that we ought to go more on the spending side than the tax side.

You brought up protectionism and I'm going to ask you something probably that could be related to your job.

PROTECTIONIST POLICIES

At the IMF, the IMF is encouraging the LDC's and other countries that have problems to reduce their imports and increase their exports. Now if they ask them to reduce their imports, aren't they going to have to go to more protectionist policies to do that?

Mr. VOLCKER. The IMF, as a matter of general basic policy, is always in favor of open markets, reduced protectionism.

Senator MATTINGLY. How can they tell them don't bring in anything, but ship everything out?

Mr. VOLCKER. In brute force terms what they are basically saying is cut your internal deficits and that will have an impact on how many resources you're absorbing at home and the consequence of that will be reduced imports. They are not saying put on import control.

Senator MATTINGLY. Is that a good rule for any country?

Mr. VOLCKER. It's a good rule for countries that have a deficit.

Senator MATTINGLY. Can you name one that doesn't have a deficit?

Mr. VOLCKER. There may be a few around the world, but you're talking about very big deficits here. You're talking about a Mexican deficit of 17 percent of GNP; the Brazilian deficit is 13 percent or something like that. These are very tough programs. We talk about our budget deficit of 6 percent of GNP as far too big, taking too many resources, too many savings. Their deficits relative to GNP are 2 or 2½ times what ours are; they're being asked to cut them in half in a year and they have a real tough program.

Senator MATTINGLY. I was just a little bit concerned about having that policy and whether that's consistent with what we're talking about.

Mr. VOLCKER. I think it certainly is because open markets is a fundamental principle of the IMF.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Chairman Volcker, we both have New Jersey roots, but that doesn't mean we have to be kind to one another.

Mr. VOLCKER. No.

Senator LAUTENBERG. Just a few things to help me understand the process a little better. First of all, productivity and jobs are tied together in the situation that we see with the IMF, as Senator Mattingly has said. Is that part of the adjustment process we're asking of the borrower: To increase exports so that they have a better balance which, in fact, may be resulting in a decline in imports from the United States?

Mr. VOLCKER. It already has by large amounts.

Senator LAUTENBERG. So we will continue to see a reduction, will we not, in the job market here?

Mr. VOLCKER. I think we will see a reduction in the export market for some time for that and other reasons. The total job market involves in a lot of other things, but in that portion of the job market, yes.

Senator LAUTENBERG. It will be under pressure?

Mr. VOLCKER. Yes.

Senator LAUTENBERG. OK. Do we penalize ourselves in some way, Mr. Volcker, as we finance these loans? I understand there's a larger order of magnitude in terms of the stability of the international economy; but do we penalize ourselves as we shore up some of these very shaky economies at the expense of investing further, if we run into very serious risks in terms of delinquencies, default, et cetera?

Mr. VOLCKER. I think it's quite the contrary. By shoring up their financial position, as you put it, we are helping them make the adjustment that they have to make. What they are being asked to do is severe, but it's less severe than if they didn't have this support. If they had all credits cut off, they would have an even more difficult time internally and their imports would go down even more. They simply wouldn't have any money to pay for them.

While we're talking about programs that have an impact on our exports—even putting aside the financial side of the equation, which you can't forget about because it's central—you would have a more severe impact if you didn't have the shoring up through the credit side, as you put it.

Senator LAUTENBERG. OK. I think there's testimony, if I'm not mistaken, on that tomorrow.

Mr. VOLCKER. Yes.

Senator LAUTENBERG. In terms of the question on short-term interest rates, does the new type of short-term investment opportunity the NOW, super NOW, money market and so forth—force such competition for funds that it would be very difficult for short-term interest rates to fall because the liquidity that's required means that that capital has to be constantly available—readily available?

Mr. VOLCKER. If you're getting to the point that this shifts a lot of money into banks that's instantly available on demand, very liquid money in that sense. I would not think it would make them more cautious about extending loans in general but it could make them more cautious about extending loans at fixed rates for any period of time. I think that's quite possible.

That's the way it should work in some sense, to make it a little harder to get fixed rate loans for a period of time, all other things being equal. Against that, some banks become relatively flush with funds and they have to look for someplace to put them and make some money. But, in principle, the more the banks shift to very liquid money on the liability side of the balance sheet, the more cautious they may be on the asset side.

Senator LAUTENBERG. The thing I think we're going to be finding is that with the premiums, with the services, with the transaction volume and so forth, the banks are going to have actually less return on their investments.

Mr. VOLCKER. There's no doubt there are quite heavy costs involved at least in the short run, and I think probably it's made them more cautious about reducing lending rates during this period of time which, again, over time, should be balanced by the fact they've got more money and they've got to lend it someplace.

Senator LAUTENBERG. Yes, except I think it will continue to put pressure on short-term interest rates because they are not going to

be able to recover a return on their investment that makes economic sense for them.

Mr. VOLCKER. We'll see how it works out. It could, all things being equal, result in relatively higher short-term rates over a period of time. I don't know how to measure that precisely, but it may go in that direction.

Senator LAUTENBERG. Have we had enough experience with these new kinds of money instruments to form any opinions as to whether they ought to be restricted in any way? Should they be encouraged? Should there be any legislative direction or regulatory direction?

Mr. VOLCKER. They are encouraged enough from my point of view. There aren't any restrictions on them. It's no great secret that I would not have designed the instrument exactly the way it was designed. We've got a hybrid of transactions and savings elements in this instrument. I would rather have had a cleaner distinction between the two and not have had so much of it piled into accounts available on demand. I don't think there are going to be any changes in the foreseeable future. Congress legislated this effect.

LONG-TERM LOAN AVAILABILITY

Senator LAUTENBERG. It does, though, doesn't it, compete directly with longer term loan availability, mortgages, et cetera? We have had testimony here from people in the housing sector and there is a question about how much money is available for long-term fixed rate mortgages.

Mr. VOLCKER. As I indicated, the more this money is highly liquid and shiftable, everything else equal, the more cautious you would think banks and thrifts would be about making longer term commitments, but it's a matter of degree. Thrift institutions were highly dependent on pretty liquid money for years and made long-term investments. I think the more important factor by far, over time, would be the general climate of confidence about future interest rate levels and whether people have the confidence necessary to make a long-term commitment. So far as the mortgage market is concerned, that is turning more and more into an instrument that is financed in the open market through GNMA securities or Government-sponsored means for converting a nonmarketable instrument into an instrument that can be sold in the open market. There are private developments where mortgages are put into more direct competition with bonds, so that you find mortgage rates following bond rates more directly these days than they did 5 years ago or 10 years ago. It's no longer so much the captive of institutions.

I think this kind of institutional development probably pushed us in the direction where mortgages have to compete more on the open market, and the mortgage rate will depend upon what the open market rates are.

Senator LAUTENBERG. Will that encourage, in your judgment, a return to the more conventional long-term fixed-rate mortgage? Will investors get burned along the way and take the loss as inter-

est rates increase—occasionally finding people left holding the hot potato?

Mr. VOLCKER. I think the future of a long-term fixed-rate mortgage is basically dependent upon the inflation outlook and the interest rate outlook that's derived from that.

Senator LAUTENBERG. It's hard to imagine that we will get back to the kind of mortgage system that existed.

Mr. VOLCKER. I think it will be a different system, but we can have a lot of fixed rate mortgages in a new system.

Senator LAUTENBERG. Fixed rate but long term as well?

Mr. VOLCKER. I think long term as well, if we can restore confidence on the inflation side. There's a surprising amount of long-term lending going on right now. I think our estimates show 60 percent of mortgage money is fixed term.

Senator LAUTENBERG. That's what they say, but it also means that 40 percent is not. That's variable.

Mr. VOLCKER. Ten years ago, it all would have been fixed.

Senator LAUTENBERG. Absolutely. In terms of putting some proper pressure on the deficit—and you may have said this before—how do you feel about the tax cut coming up here in the middle of the year? Do you think we ought to let it stand as it is?

Mr. VOLCKER. You've got to do something about the deficit in my judgment. If I had my choice, and given the situation in the economy at the moment, I suppose that wouldn't be first on my priority list in terms of its timing with regard to the budget.

Senator LAUTENBERG. Thank you.

The CHAIRMAN. Thank you, Senator. If I could just make one comment on the issue of new money market accounts, I suppose I'm constantly defending my child, but some comments that don't seem to be made now that it is being much more successful than a lot of people anticipated, and this point was made in hearings on Monday or at least I tried to make it—the fact that on the daily availability of this money for a good deal of it where a very large proportion of it is coming from is traditional passbook savings that was readily available on a daily basis as well.

Mr. VOLCKER. That's correct.

The CHAIRMAN. So that simply is not a change. I heard that comment made from some of the witnesses from financial institutions. It's not any more readily available than it was.

Mr. VOLCKER. I think that's certainly very true. If you go back 10 years, thrifts were totally dependent on passbook savings. I think they were operating in a different climate, where there was more stability in those savings than there is in any instrument now, but that's a reflection of the total economic climate not the instrument.

The CHAIRMAN. Second, about being expensive, isn't it true that they are far simpler accounts to manage than the very complex sweep accounts that certainly put an upward pressure on money. Also, the money market funds in excess of $200 billion that were being removed from these institutions were accomplishing two things. First of all, taking away liquidity which was then not available at all for mortgage loans, automobile loans, consumer loans or anything else, and being put into quite different purposed by the money market funds, the new boys on the block, and also putting S&L's in a failure mode where we faced a list of nearly 1,000 trou-

bled S&L's as a result of that lack of money and many of them not making loans at all.

So I really reject—not just in a defensive manner, but I reject that there is any more certainly upward pressure on interest rates as a result of this new account compared to the struggles of these depository institutions in the last 2 years to find enough money to loan, sweep accounts, the administrative burden of that, passbook savings—that whole scenario, which I do believe had a certain upward pressure. But I'm intruding on Senator Hawkins' time.

Senator HAWKINS. Good morning. Mine will be a potpourri of questions that have not been asked by others.

RECOVERY DEPENDS ON CONSUMER SPENDING

Many economists and commentators believe that the size of the recovery will depend to a large degree on whether consumers start spending. Interest rates on installment credit extended by banks for durable assets remained at 18 percent through 1982. Credit card rates stayed at 19 percent. Rates charged for car loans at year end were 16 to 17 percent. Yet the CPI went up only 4 percent.

That means that the real or inflation adjusted interest rate for consumers is 15 percent from the figures that I have.

Isn't it highly unlikely and almost impossible for consumers to start a recovery if interest rates aren't cut? What is the Fed doing to lower them?

Mr. VOLCKER. The interest rates you're referring to, of course, are set by banks and other institutions and they are somewhat removed but certainly influenced by the interest rates in the market that we talk about more commonly. You're certainly correct that those interest rates have held at exceptionally high levels during this period of declining rates.

There was clear statistical evidence that they were declining late in the year, but not by very much. I don't have statistical evidence beyond that.

I think perhaps before you came in, Senator, I said my sense is, in an informal way, that those interest rates are declining more rapidly now but still they are high.

To the extent they are reduced, you're going to help the consumer side of the economy. They are being reduced some. It comes back in part to how confident people are, as I said earlier, about the fact that interest rates will stay down, because once a bank makes a consumer loan for 3 or 4 years it is on the books for 3 or 4 years and the banker is interested not just in what the interest rate is today on the market but in what it's going to be next year and the following year. You get back to this confidence question in part.

The consumer rates are also sluggish. They are particularly sluggish now, but I would be hopeful, if market rates stay down, those rates would continue to come down by very noticeable amounts.

Senator HAWKINS. How would you feel about setting a credit card rate at 15 percent right now, to lower "real" consumer rates to reasonable levels.

Mr. VOLCKER. I haven't any opinion about a particular rate. The credit card rate over time has been the stickiest of all rates. Rates are kept the same year after year, typically, unless there is a major

change in the interest rate picture over a long period of time. Credit cards have a lot of operating expenses; there is a certain amount of credit loss; and they don't like to change the rates frequently as a marketing or operational matter.

Senator HAWKINS. What has been happening to credit card rates charged by commercial banks?

Mr. VOLCKER. Department stores probably have higher rates than the banks, or equally high rates. That's going to be the last area to make a change. When they make a change, it tends to be more permanent.

I think you will find the data actually suggests that last year credit card rates were going up during the year while other rates were going down. I think the reason for that is probably that many States were relaxing usury laws and banks and others were looking to increase their rates to what they thought was the appropriate level; you had declines in rates by some during the year, but others getting a relief from the usury laws, were increasing rates.

Senator HAWKINS. In recent weeks both spot and long-term oil prices have fallen rapidly placing downward pressure on inflation and improving chances for economic recovery. How should the Fed respond to this favorable development?

Mr. VOLCKER. I'm not sure that any particular response is required. I think to the extent that helps the inflation rate, it helps us and it helps interest rates, and you will see some response in the marketplace. And, of course, that affects, over time, the discount rate and other things. But I'm not sure that a decline within a moderate range has direct implications for our actions today.

If you saw the collapse of the oil prices, then you'd have a series of potentially good things and also a series of problems you would have to worry about.

Senator HAWKINS. Well, there have been alarmists telling us that banks will not be able to stand a dramatic fall in oil prices.

Mr. VOLCKER. I don't think you would say that about the banks in general. There's certainly room there for some decline without concerns about the financial system, but if you get an enormous decline, you've got problems in the energy industry here.

Senator HAWKINS. What did you do when they were going up so rapidly, anything? When oil went from $2 in 1972 to $11 and then $11 to $20 and $20 to $38?

Mr. VOLCKER. I think a lot of people say, in retrospect that the Federal Reserve—I was not in the Federal Reserve at the time—was too accommodative in permitting the money supply to increase during that period of inflation. It, obviously, contributed to inflation, and it was a matter of judgment as to what extent that should be accommodated.

Senator HAWKINS. There is talk—and I'll repeat it— that within regulatory services; between the Federal Reserve and the Comptroller of the Currency about maintaining a 10-percent reserve against perceived problem loans. Are you aware of that?

Mr. VOLCKER. We are working on a number of approaches in that area. That, I suspect, will come up in the hearings tomorrow. We've not got a plan or a position at this point, but various options in that area are under most intense consideration so that we can come back to you before you finally consider this IMF legislation.

SELECTING MEMBERS OF THE BOARD

Senator HAWKINS. That's tomorrow. The Federal Reserve Act specifically states that the President when selecting members of the Board must show a due regard to a fair representation of financial, agricultural, industrial and commercial interests, and the geographical divisions of the country. Could you tell me how you give due regard to those different interests as well as geographical divisions of the country regarding the present makeup of the Board?

Mr. VOLCKER. You ask how we give consideration to it. You're directing the question to the wrong person; I don't make those appointments. But that has been a matter of some discussion through the years. I know Senator Garn has been very interested in getting a variety of points of view on the Federal Reserve Board.

That is a general philosophy, which I happen to agree with. Senator Proxmire, at one point, had a somewhat different idea, maybe not inconsistent with a variety of points of view. He has encouraged appointments of professional economists to the Federal Reserve Board. I like the idea of a certain amount of diversity on the Board. It's hard to take account of that representation on any specific Board because you only have seven members and you've got a lot of things to be taken into account.

Senator HAWKINS. All seven presently are monetary economists, are they not?

Mr. VOLCKER. I don't know whether I would list myself as a professional economist; that leaves at least five Board members who are economists. I don't know whether Governor Martin would or not. He's had a career in the savings and loan industry and private mortgage companies, but he started out as a professor of economics 30 years ago I suppose; he's been away from it.

Senator HAWKINS. So five economist and one practicing—you're not a professional, but you're practicing——

Mr. VOLCKER. I'll let myself be neutral at this point. All the members of the Board have had professional economic training; that is correct.

Senator HAWKINS. All members with the exception of Mr. Martin have been former Federal Reserve Bank employees?

Mr. VOLCKER. Not all have been Federal Reserve Bank employees. I'm making a technical distinction. Mrs. Teeters was a Federal Reserve Board employee at one point; that's a distinction without a difference I suppose.

Senator HAWKINS. She was a staff economist for the Federal Reserve Board's Division of Research and Statistics, 1956 to 1966?

Mr. VOLCKER. That was Governor Partee, I think. Governor Wallich worked for the Federal Reserve Bank of New York 30 years ago; Governor Partee worked for the Federal Reserve Bank of Chicago 20 years ago; Governor Teeters was a member of the Federal Reserve Board staff; Governor Rice I think briefly, for a year or two, worked for the Federal Reserve Bank of New York early in his career; and Governor Gramley was an employee of the Federal Reserve Bank of Kansas City in his career and he was on the Board staff for a long while.

Senator HAWKINS. What about Governor Partee, did you mention him?

Mr. VOLCKER. He was the first one I mentioned. Both Governor Partee and Governor Gramley have been on the staff of the Federal Reserve Board.

Senator HAWKINS. Would you recommend that we rewrite the law and say that all Federal Reserve Board members shall be former Federal Reserve employees and economists?

Mr. VOLCKER. With great emphasis, no.

Senator HAWKINS. So would you say then that the present Federal Reserve Board that's been appointed by Presidents along the way are not in compliance with the Federal Reserve Act?

Mr. VOLCKER. I wouldn't say that. They can have other experience as well as once having worked on the Federal Reserve. My first permanent job was with the Federal Reserve Bank in New York and I don't like to think that that left me scarlet-lettered or illegal.

Senator HAWKINS. No, I didn't say it's illegal. I'm just saying either you're all economists or former Fed employees.

Mr. VOLCKER. An ideal Board member in some sense would have some experience of this sort, but other experience as well. If you could combine the two, you've got an ideal situation.

Senator HAWKINS. I'm sympathetic with the view of our chairman who says the Fed should be broadly representative of diverse industries and regions.

Mr. VOLCKER. So am I. Just to give you an example, Vice Chairman Schultz who left the Board a year or so ago had no experience with the Board. He had some banking and other experience. He brought a very valuable perspective to the Board of Governors, not just from Florida but from a wider area. He was an excellent, strong member.

Senator HAWKINS. Thank you. My time has expired.

The Chairman. Senator Sasser.

Senator SASSER. Chairman Volcker, you and I have been jousting together now for about 3 years, first before the Budget Committee and here before the Banking Committee. During that period of time, we have had a lot of conversations about inflationary expectations, and the problem of inflation I think has been your principal concern and perhaps rightfully so.

I'm beginning to think now, though, that we have become fascinated or hypnotized by this serpent in the corner of the room we call inflation while the house is burning down around us.

Now you have said time and time again that we needed to do something to defeat this inflationary expectation, that we need to quench this fire. Well, what about growth expectations?

Now we've got inflation down to the lowest level in about 20 years, if I'm not mistaken.

Mr. VOLCKER. Ten years.

STIMULATE GROWTH EXPECTATIONS

Senator SASSER. And if you have to defeat inflationary expectations and that takes time, how do you stimulate growth expectations? Now this administration is predicting growth at the rate of 3 to 4 percent. If that is true, it's going to take almost 10 years just to take up the slack in the idle industrial capacity that we have

now; and some economists tell us we have to grow at the rate of 3.5 percent a year just to take care of new individuals coming in the work force and take care of more efficient productivity in the economy.

You were talking a moment ago in terms of what we might be on the verge of if we stayed the course and didn't throw away the gains that we had already made—that we might be on the verge of a long and sustained recovery. I look here at 1982 business investment; it was down 8.4 percent. It's predicted to be down in 1983. In the tax bill in 1981, we gave more liberal depreciation allowances to business, all in an effort to stimulate business expansion and I suppose recovery. But the Congressional Budget Office tells us that real interest rates have eaten up or been twice as big as the decrease in real after-tax rates resulting from lower inflation and resulting from higher depreciation schedules that we gave for business. So that's been lost.

My question to you is, when do we get away from this focus about feeding inflationary expectations and when do we start stimulating some growth expectations? I strongly suspect that we're going to have to have 2 years at least of high-level sustained growth before we are going to start getting an increase, getting new plants built in this country, and making a significant inroad in unemployment. How are we going to get this growth expectation going with these continued short-term high interest rates?

Mr. VOLCKER. Basically you put your finger on it: Our economic problem has developed as a result of 10 years of unsatisfactory performance which shook the basic confidence of the American people in the inflationary outlook. That creates a very difficult dilemma precisely for the reason that you suggest—it takes a long time to deal with inflationary expectations.

The problem is—and I tried to deal with this in my statement—I don't think we have a choice. The market will not permit us to say let's forget about inflation now and create, as you put it, an expectation of a climate of growth. We've got to do both together, because if we don't I think we are doomed to failure precisely because inflation expectations will feed back through the interest rates and you will get a level of interest rates that won't be consistent with the growth that you and I want.

People have varying views on this. I feel rather optimistic that, given the progress we have made on inflation, given what seems to me the clear case that can be made for this to continue and to continue consistent with the signs of recovery we now see, that we are building a base in which, indeed, we can have both—lower interest rates and recovery—as I think we must.

If I knew some buttons to push to hasten that process, I would push them, but I don't think I have those buttons. To put it another way, we are doing the best we can, in my judgment, just to create that kind of climate where we can have——

Senator SASSER. Mr. Chairman, I would urge you to push the button that would create some lower short-term interest rates.

Mr. VOLCKER. That's specifically——

Senator SASSER. I think that's really what we need to get this economy moving again.

Mr. VOLCKER. Nobody has given me the button to push to get short-term interest rates free of any other consequences. I've got to worry about that growth in the monetary aggregates; I've got to worry about the expectations that sit out there. We've got to make that judgment all the time. Maybe I've got a crippled computer or something, but I can't just push a button and make everybody else behave the way I would like them to behave.

CONTINUED CREDIT TO DEBTOR NATIONS

Senator SASSER. Let me shift gears here for just a moment. You're deeply concerned about the strains on our international system partly brought—in fact, largely brought on by the current recession—the recession in the United States, in some areas a depression, and a recession in the economies of our trading partners around the world—and the problems with the less developed countries. You stated in recent testimony before the House Banking Committee that we ought to increase our support of the International Monetary Fund and provide continuing credit to those debtor nations so they can maintain continuity of payment. Some of them can't even pay the interest on their loans without help. They can't pay the interest on their loans, I'm told. Quoting from your testimony before the House, you said, "Failure to deal successfully with immediate international financial pressures that only jeopardize prospects for our recovery"—talking about our domestic recovery—"for our jobs, for our export markets and for our financial markets." Now I'm advised that 35 percent of our GNP lost in the recent recession is due to a decline in exports and because the high interest rates in this country have caused our currency to appreciate dramatically against that of a number of our trading partners. Since 1979 it's gone up 50 percent vis-a-vis the French franc, 53 percent vis-a-vis the German mark, 36 percent vis-a-vis the Japanese yen, which makes it much more difficult for our goods to penetrate the export market abroad because they are more expensive and makes the importation of these other goods cheaper, displacing workers here at home with imported goods.

Now if it's important for us to stimulate the international market or keep that international financial system by infusion of funds in the International Monetary Fund so we can protect our export markets, why isn't it just as important for us to bring interest rates down in this country so that we can also allow our business people to compete on a fair level with other businesses abroad so we can have a significant penetration of the export markets and have fair treatment with regard to imports coming into this country?

Mr. VOLCKER. I'd like to see interest rates in this country just as low as we can have them, consistent with our objectives over time.

Senator SASSER. Well, I think that's the problem, Mr. Chairman. I think there's a gathering view that maybe we ought to be going about this in a different manner. Now I know that you want lower interest rates consistent with what you think our monetary policy ought to be.

Mr. VOLCKER. Right.

Senator SASSER. But there are some of us and I suspect some on this committee, who respectfully disagree with that and feel that what this economy needs now is lower interest rates, to get it moving, and to get a solid recovery coming.

Mr. VOLCKER. I would be delighted to see that.

Senator SASSER. Without it, I don't see it coming. That's my problem.

Mr. VOLCKER. Just to repeat something that we all know, the Congress can make an enormous contribution to that by dealing with the budgetary problem, because that is one action that can be taken that is entirely consistent with our long-term and medium-term goals as well as with what the situation requires today. It's almost uniquely fixed in the sense that it's good in the long run and it's good in the short run, so that's an action that I can recommend to you without any reservation at all.

On the monetary side, certainly, we have to have that consideration in mind, but I think we are in a little more ambiguous position as to what to do today in terms of interest rates and our effectiveness over a period of time. Whether it's good or bad and whether it will be productive or counterproductive is a matter of judgment, and there's no escape from that judgment. We've got to make it, and I'm giving you my best judgment as to how to balance this thing out.

That doesn't say whether interest rates are going to go down or not, because it depends upon other things, but those are the judgments we are constantly making.

Senator SASSER. Mr. Chairman, my time is up. I got a telephone call from one of my constituents who asked me to ask Chairman Volcker a question. He said, "Senator, will you ask the Chairman if he is going to seek reappointment as Chairman of the Federal Reserve Board," and my constituent didn't express an opinion one way or the other.

Mr. VOLCKER. I don't seek jobs.

Senator SASSER. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Is the follow-on to that response that the job seeks you, Mr. Chairman?

Mr. VOLCKER. In this particular instance?

Senator SARBANES. As a general proposition, do the jobs seek you?

Mr. VOLCKER. I think it's fair——

Senator SARBANES. Is that the follow-on to that response?

Mr. VOLCKER. I suppose it's fair to say I interpret that to have been the case in 1979.

BANKS KEEPING INTEREST RATES HIGH

Senator SARBANES. I notice in today's paper that Secretary of the Treasury Regan, when citing reasons why interest rates have not fallen closer to the levels that might be expected in a sluggish economy with a low rate of inflation said—and I'm now quoting the newspaper quote of him—"I think the third one, being very candid, is bank earnings, Mr. Regan said. I think the banks faced with a lot of problem loans both domestic and international are doing

their utmost to keep their earnings by keeping their interest rates up."

Do you agree with that?

Mr. VOLCKER. I think banks have been cautious in reducing the prime rate or some of the other rates partly because of those circumstances, partly because of the concern of the cost of this new account. I think that was perhaps evidenced more on the credit side some months ago than now, but the spreads between the prime rate and other rates have been relatively wide and I think that's part of the explanation.

Senator SARBANES. The American Bankers Association, in a statement denying Mr. Regan's assertion about earnings and interest rates said:

> There are no doubt data available to support a charge that banks are holding interest rates artificially high to build up earnings in anticipation of domestic and international bank loan losses.

What's your comment on that?

Mr. VOLCKER. I guess I could make the same comment I just made. It's very hard to know how important a factor this would be. I think it led to some caution at times. It's hard to measure what effect that may have in the actual level for the prime rate. We do know that the prime rate for a loan——

Senator SARBANES. So you think banks are keeping interest rates artificially high?

Mr. VOLCKER. You say artificially. For a variety——

Senator SARBANES. Well, a direct conflict here between an analysis by the Secretary of the Treasury there is the factors causing high interest rates and the response of the banking community. You're the Chairman of the Federal Reserve Board. What's your position?

Mr. VOLCKER. I have expressed the opinion that I think this was a factor leading to a more cautious rate of reduction, a slower rate of reduction in the prime rate than might have taken place in other circumstances, given the level of market rates and all the other things.

Senator SARBANES. So you think there was merit to Secretary Regan's observation, is that right?

Mr. VOLCKER. To that extent; yes.

Senator SARBANES. OK.

Mr. VOLCKER. I don't think that's sustainable over a period of time. I think you're talking about lags here. You're not talking about——

Senator SARBANES. We have been talking about lags and periods of time for a long time.

Mr. VOLCKER. Right.

Senator SARBANES. The assurances you're giving now are the same sorts of assurances you offered a year and 18 months ago. You say you're optimistic about where things are going and yet your own statement predicts an unemployment rate of over 10 percent for 1983 in this country. Now that's not optimism for the unemployed.

Mr. VOLCKER. No, that's true, and that's where we are.

Senator SARBANES. It certainly is true. What consultation has there been between the Federal Reserve and administration officials recently and particularly, with respect to the monetary policy accord?

Mr. VOLCKER. There wasn't any direct consultation on these targets that I was presenting today. I have had continual contacts with members of the administration, as I always do.

Senator SARBANES. With the Secretary of the Treasury, for instance?

Mr. VOLCKER. Yes.

Senator SARBANES. Is that on a regular basis?

Mr. VOLCKER. It's regular and irregular. We usually try to meet regularly but we can meet many more times than regularly scheduled.

Senator SARBANES. What's the regular schedule?

Mr. VOLCKER. We try to meet at least once a week.

Senator SARBANES. When did you last meet with the President himself to discuss our Nation's economic situation and how we ought to address it, and what our economic policies ought to be?

Mr. VOLCKER. A week or 10 days ago.

Senator SARBANES. With the President. When did you meet with him prior to that?

Mr. VOLCKER. It's been——

Senator SARBANES. That's about the first meeting in a year, is that correct?

Mr. VOLCKER. Directly to discuss these problems, yes.

Senator SARBANES. But there was a meeting a week or 10 days ago?

Mr. VOLCKER. That's correct.

Senator SARBANES. To go into these issues?

Mr. VOLCKER. Correct.

Senator SARBANES. Well, that's a step forward. The last time we asked you that question there hadn't been a meeting in about a year's time.

What is the relationship, if any, between monetary aggregates and interest rates?

Mr. VOLCKER. Complex.

Senator SARBANES. Is there a relationship?

Mr. VOLCKER. Yes.

Senator SARBANES. So it does matter what you do with respect to monetary aggregates as far as interest rates are concerned?

Mr. VOLCKER. Yes, but it matters in a complex series of ways. In a completely static situation, expectations unchanged, you would expect that the more money, the lower short-term interest rates. But we obviously don't live in a static kind of world. The question is how does any one of our actions affect expectations and other elements in the economy over a period of time. That all influences interest rates.

I pointed out earlier a slightly different facet of operations, but it is tied in with the aggregates. Sometimes we can reduce the discount rate and interest rates will go down. Sometimes, like in December, we can reduce it and interest rates don't move down.

Senator SARBANES. Is it kind of a happenstance business? You just do it and hold your breath to see which way you're going to go?

Mr. VOLCKER. We make the best judgments we can.

Senator SARBANES. I know, but what are those judgments related to?

Mr. VOLCKER. I don't consider that happenstance. We try to assess what's going on in the business world. We try to assess the inflationary situation. We assess all the indicators we can get and even sometimes try to anticipate interpretations that others will put upon our actions.

Senator SARBANES. You've got unprecedented real interest rates; is that correct?

Mr. VOLCKER. No.

Senator SARBANES. You don't find the current real interest rates way out of line to start with?

Mr. VOLCKER. I think they're very high. You asked me if they're unprecedented.

Senator SARBANES. What's the problem with unprecedented? Would you regard them as being historically as being very much out of line?

Mr. VOLCKER. Historically, they are high; yes.

Senator SARBANES. They are very high?

Mr. VOLCKER. When you say real interest rates, the relationship between the current inflation rate and current interest rates is high historically, no doubt about it.

Senator SARBANES. Do you think you can have the recovery to speak of, a strong sustained recovery, which will reduce unemployment at the current levels of real interest rates?

Mr. VOLCKER. As I indicated earlier in discussions with Senator Riegle, I think over time with the kind of inflation picture I see, yes, I think interest rates——

Senator SARBANES. I want to clarify when you were responding to Senator Riegle whether you were talking about real interest rates. That word was never in there.

Mr. VOLCKER. All right. Let me add it.

Senator SARBANES. Interest rates can drop, but if the real interest rates remain at a very high level you will continue to be confronted, in economic terms with the problem that Senator Hecht identified.

REAL INTEREST RATES

Mr. VOLCKER. Let me respond to the question on real interest rates. First of all, let me say you can only know what the real interest rate, in one sense, is after the fact. You can't even know then for a fact—it presumably involves an expectation of the rate of inflation. Let's compare it with the current rate of inflation and take that shorthand for a so-called real interest rate.

Yes, I believe that over a period of time the real interest rates should and probably will have to be lowered to sustain the kind of recovery I would like to see over a period of time. Now let me say in that connection——

Senator SARBANES. In other words, we cannot have a strong, sustained recovery at the current levels of real interest rates?

Mr. VOLCKER. I think that's unlikely, for an extended period for the kind of recovery I would like to see. If you tell me that the Government is going to run deficits at $200 billion during this period, you might have some kind of a lopsided recovery, because you're going to be pouring out a lot of consumer purchasing power. You're also going to have relatively high interest rates under those conditions. It's not the kind of recovery I'd like to see. It's not the kind of recovery this country needs. You asked me whether it's impossible; I don't know whether it's impossible to do that.

Senator SARBANES. The deficit is created by the soft economy. Do you counsel the Congress to move to close that deficit by spending cuts or tax increases?

Mr. VOLCKER. No. The problem is, if I may supplement that answer, the deficit we're facing in coming years.

Senator SARBANES. I don't think we probably differ much over whether there's something wrong in an economic policy that projects a 6-percent unemployment rate/assumes that in those economic circumstances that we're going to run a very large deficit because of the imbalance between spending and revenues. That could be connected on either side but, nevertheless——

Mr. VOLCKER. Nobody knows precisely what the numbers are, but I think there's very wide agreement about that.

IMPACT OF HIGH INTEREST RATES

Senator SARBANES. What part of the deficit problem if you accept the proposition that the high interest rates have contributed to the economic downturn, has been created by the high interest rates, the impact they have had on economic activity?

Mr. VOLCKER. A good part of the current deficit, I think probably a majority of the current deficit, is related to the recession. You can ask other questions about what created the recession.

Senator SARBANES. Do you think high interest rates have helped to contribute to the slowdown of economic activities?

Mr. VOLCKER. In a direct sense, yes, but you have to go into many questions about why that happened.

Senator SARBANES. My time is up.

The CHAIRMAN. At this point, I know Senator Riegle has requested time for additional questions. I'd just like to request that we adjourn at 12:30. Do other Senators wish to have additional questions? Let me turn to Senator Riegle and then Senator Hawkins.

Senator RIEGLE. Mr. Chairman, picking up where we were earlier, I want to refer to some items in the Wall Street Journal of yesterday and today. Yesterday I'm sure you probably read an article on the front page and the headline reads as follows: "Despite Recovery Talk, People Don't Indicate Any Shift to Optimism. The Wall Street Journal Survey Finds Joblessness Disturbing." In today's they have a different feature story and it says "Firms Question Signs of Recovery and Worry About Another False Start." And this is a survey of business people across the country and there are a number of interest observations in here but one of the paragraphs that relates to this discussion that we're having reads:

What would it take to convince skeptic executives that a genuine recovery is underway? Many say a further decline in interest rates is the most important signal. Conversely, rising interest rates would convince some that the recovery will abort.

But they mention interest rates as their main thing.

We mentioned just briefly as you were coming into the room about car sales and there's been a modest uptake in auto sales, partly due to the fact that the companies have offered them at below market rates, but the sales pattern is below what it was a year ago at this time.

But perhaps more significantly, to those of us that follow the car industry closely, is the fact that Chrysler Corp. announced yesterday that they're going to incentives and that's warmly seen as a sign about concern in the weakness in the market and the feeling that something more has to be done to induce sales activity.

So that is not necessarily an encouraging sign if one wonders about the psychology and I cite those things but I could cite lots of others to say that I think the dominant psychology at the moment out there is one of skepticism with respect to whether or not we're really on the road to recovery.

Earlier you said if interest rates stay where they are now that you thought that we could in fact get a strong and sustained recovery going here and maintain it.

Mr. VOLCKER. You were talking in a narrower time frame.

Senator RIEGLE. I'm talking about the next several months. I think this is the time period in which we kick off a recovery or we fail to do it. I happen to think that's a very important time frame myself and that's shared by most of the people I speak to in the business community.

With that is part of the proposition that I'm putting to you. I am concerned and I think it's a major miscalculation to think that interest rates at current levels will let strong recovery happen. In other words, I think we have plateaued out at an interest level here that really is insufficient to ignite the kind of recovery we need right now and I would describe that as a strong, sustained recovery.

If you look at retail sales or the other things I mentioned, there's still enough slackness there and weakness to support that notion, and I dare say I think if the message goes out here today to the business community and to people across the country that the Fed in essence feels that we can get a recovery with intereest rates at this level and not having to go lower, that that will really jolt an awful lot of people. I don't think that will be seen as a positive signal quite frankly. In fact, I think that will make people nervous and justifiably so. I think you found that with respect to actions that the Fed can take, the discount rate being a very specific one, I think you have been able to demonstrate an ability to help move interest rates down and I think the time may be ripe—in fact, I think it is ripe for further reduction in the discount rate and I think that would be helpful.

NEED FOR FISCAL TIGHTENING

But let me add one other point and then I welcome your comments on it. All this has to be said in the context of the fact that

we found we need fiscal tightening. There's no question about that. The overhang of the deficits in the outyears will create impossible problems for us. We've got to get those down. We've got two problems there. One is that we're not going to get a package of sufficient reductions in the deficit unless defense is a major part of that. I mean, that just has to be one of the major areas in which eventually we end up with a bottom line reduction in the deficit. The President in the last couple days has given a strong signal that they are going to mount a major public relations campaign in the country against any further cuts of any consequence in their defense request. I would just say to you that I think that's kind of a linchpin and we can watch that and if we're going to get the overall package of savings with revenue and spending, defense is going to have to be part of it. So that's one of the concerns that I think anybody analyzing this situation would have to raise right now.

The second thing is this. Under the best of circumstances, just working out the fiscal decisions are going to take us period of months just in the normal course of events. So if we're in a very sensitive time period here where recovery needs to start and we hope is starting and we hope will continue, it may not be until 4 or 5 months from now that you're going to get the precise fiscal answer in the form of actions taken by the Congress.

In this interim, it seems to me I think we may need some monetary easing, some further monetary easing. And if that's not the view of the Fed, then my feeling of apprehension goes up quite sharply and I must say to you that I find that reflected in the views of many people in the business community that I speak to, including many in the New York City financial industry.

Mr. VOLCKER. Let me make a couple of comments, hopefully short, to clarify my own position. The kind of comments you quote from that article, I obviously hear very frequently, too. I think it's a good characterization of many elements of opinion in the business community and elsewhere. I don't know whether you asked me whether it was possible to have recovery at current interest rates or whether I responded that it was possible. I didn't respond that I was delighted by that prospect. I would like to see interest rates lower. Obviously, the lower interest rates are, the more assurance you have for a good recovery.

What I did say is that we had to balance that kind of concern against other concerns. That article you quoted from focuses on the other concerns in a very precise way: It said some of the businessmen were worried not so much about the current level of interest rates but about whether they would go up, and that that would abort a recovery.

I tell you that we have to judge our current actions in a context of whether we increase that risk, and I don't want to increase that risk. I don't want to go back to the kind of interest rates we had before. I want to take advantage of this situation, because I think lower interest rates—real and nominal—are desirable and necessary over time and can be achieved.

Senator RIEGLE. Let me just stop you there for 1 minute because I understand that distinction but that's why I put the question initially in a very narrow way, and that was to ask you if rates did not go down lower which we would all like to see whether the re-

covery in fact would be able to take hold and continue, and I think you clearly said that you thought it could and would.

Mr. VOLCKER. That's right, but with less assurance than if rates were lower. When you get into balancing these factors, you say and I understand that you can't deal with the deficit in the immediate future, but that fact is hanging there. So long as that fact is hanging there it maximizes the possibility of getting adverse reaction—of people thinking that the Federal Reserve is going to monetize the Government debt or is not going to monetize the Government debt—and either way it's an impossible situation because interest rates will go up.

We can't deal with that directly. There's no way we can remove that cloud from the market. It exists and narrows our flexibility by its existence and may have an adverse effect on whatever we do today.

Senator RIEGLE. Let me say this to you, and this will sound strong, but it's a truthful assertion. I think I probably talk to as many business people as any Senator. I have an enormous concentration of business activity in my home State. I have not found a single business person in this country that would take the position that if interest rates go no lower, stay where they are, that that would be sufficient to set off a strong and sustained recovery. I'm just telling you that I can't find anybody out there who would advance that proposition.

NEED FOR LOWER INTEREST RATES

What I'm hearing from them is in fact something quite different than that and that is that through a combination of actions very specifically including fiscal tightening that we've got to get the rates lower in order to get the recovery. So that single point of difference of opinion I think is a very pivotal one.

Mr. VOLCKER. Again, we are not aiming at this level of interest rates. If interest rates were lower, we would have more assurance.

Senator RIEGLE. I realize that, Mr. Chairman.

Mr. VOLCKER. But my own judgment doesn't coincide with yours about prevailing opinion. There's no question that a lot of businessmen want lower interest rates. It's quite natural. I understand it, and I'd like to see lower interest rates, too. But when you say that it's impossible to have a recovery at this level of interest rates, I think, on the contrary, we're probably at the beginning of a recovery now, at this level of interest rates. I see many economic forecasts, right or wrong—they were wrong last spring, let me hasten to add—many business forecasts that show some recovery, and they haven't necessarily pronounced a further decline in interest rates. Many of them have interest rates pointing up a little bit.

I think the major forecasts are pretty much in that posture. That doesn't deny what you say, that businessmen would feel a lot more comfortable with a lower level of interest rates. Obviously, I would feel more comfortable about the near-term prospects with lower interest rates, but that doesn't answer my question about how you achieve that and sustain them, and that's what we're trying to do.

Senator RIEGLE. My time is up but I will have some questions for the record and I think it's a matter of making sure that we get

through the short term and we get some strength here in the short term and at the same time not lose sight of the long-term objectives.

Mr. VOLCKER. I agree with that.

Senator RIEGLE. But I'd like to pull you a little more into the near term because I think that's really critical right now in terms of getting on the upswing and staying there.

Mr. Chairman, my time is up.

The CHAIRMAN. Senator Hawkins.

Senator HAWKINS. I'd just like to talk to you a little bit about some of the statistics you used. Ten percent unemployment, deficits of $200 billion, and so forth, out into the outyears. What if there were 5 percent unemployment? What would happen to the deficit?

Mr. VOLCKER. I'm not sure just what aspect of this you're driving at. If unemployment was 5 percent today and production was up, with all that would imply, the deficit today would be certainly less than $100 billion. It might be down—I haven't got the calculation right in front of me—in the area of $50 to $75 billion.

HIGH TECHNOLOGY INDUSTRY BOOMING

Senator HAWKINS. Is it not true that the potential for growth for new businesses, especially in the high technology industries that are coming downline are mind boggling in terms of new jobs and new wealth? Take the computer industry for one. It's expected to grow from $50 billion to $100 billion in 1986, making it the biggest business in America.

Mr. VOLCKER. I haven't got any projections of that, but it's been an enormous growth industry and it employs a lot of people.

Senator HAWKINS. How about the long-distance communications? It's supposed to be $50 billion today and growing at 18 percent a year.

Mr. VOLCKER. No question that those kind of industries are the cutting edge of growth.

Senator HAWKINS. Robots and other major new industries, the increased industrial productivity, but the construction of the robots itself is showing phenomenal growth. I polled some figures that showed from $200 million in 1980 and they're projecting over $2 billion by 1985. Fiberoptics companies—that is old to me but new to a lot of people—that is going to take off again. AT&T is planning to use a telephone cable between Washington and Richmond and the new cable would have taken 2 million pounds of copper with the old-fashioned technology.

So it seems to me that there's little question that growth in the high technology industries will more than make up for the slack in the smokestack industries there.

Mr. VOLCKER. I would agree with that, but I also think that the slack in so-called smokestack industries can diminish or disappear over time, too.

Senator HAWKINS. So if we had two more Hewlett-Packards and one more Xerox——

Mr. VOLCKER. It would be nice, wouldn't it?

Senator HAWKINS. We may not be seeing the projected problems that you're foreseeing in 1985 and 1986.

Mr. VOLCKER. I think this country has great potential. My basic view of the future is that we are going to have a very long and sustained expansion.

Senator HAWKINS. And in your view, they probably will come from new companies?

Mr. VOLCKER. A lot of the growth will come from the new companies, new technology, as you're pointing out. The steel industry, the oil industry, the metals industries are going to do a lot better too.

Senator HAWKINS. But the business firms that made the Fortune 500 like GE and IBM have created no new jobs since 1976 according to the information I have, yet digital equipment and data generally generated new jobs at the astonishing rate of 40 percent a year in the same period.

Mr. VOLCKER. And, of course, we are getting a lot of jobs in the service area, too. The long-term trend is very clear; the economy is relying less on manufacturing and more on other areas.

Senator HAWKINS. And they generate wealth.

Mr. VOLCKER. And they generate wealth, too.

Senator HAWKINS. So creativity and the desire for wealth is found in all nations. The big difference in America is venture capital.

Mr. VOLCKER. I think that's an important difference, and we have to keep that alive.

Senator HAWKINS. So the Japanese may be our peers in technology and our superiors in education and industrial organization, but in your opinion, do they lack venture capital?

Mr. VOLCKER. I'm not in a position to know whether they lack venture capital. The Japanese have done pretty well.

Senator HAWKINS. What is their deficit?

Mr. VOLCKER. In the budget?

Senator HAWKINS. Yes.

Mr. VOLCKER. They have had a large deficit and they have been trying very hard to reduce it. I can give you the figure.

Senator HAWKINS. I'd like to know. I'm asked so often. Do you have Germany's, too?

Mr. VOLCKER. This is general government; this includes, in our context, State and local governments, where we happen to have a surplus. Japan's deficit is about 4 percent of GNP in 1981; in 1982 it is about 3.25 percent. It's coming down; it's on a declining trend.

Senator HAWKINS. So when we take all the figures that we get from the CBO and from the Federal Reserve and from the OMB and from the administration and all these other agencies that bring so many figures to us, it seems to me a lot of those are based on business as it is today.

Mr. VOLCKER. No, not these forward-looking budgetary estimates; they are quite specifically based upon assumption of growth in the economy. Another way of looking at them is to try to identify that part of the deficit that has no relationship to the unemployment level—structural deficit, full employment deficit, or whatever you want to call it. Taking that into account and assuming we're not going to have excessive unemployment, that unemployment will return to the average levels of the 1970's, we have a very big deficit. That's the problem in the future years. The deficit right now can be mostly traced to unemployment, not all of it but most of it.

That is not true in 1986 and 1987. I think the interesting thing is that virtually everybody's analysis coincides on this point. People have somewhat different numbers—they may differ by $25 billion or they may differ by $50 billion—but they are all saying it's going to be about $200 billion or $250 billion when you get out to 1986 and 1987, even if unemployment is down to the 6-percent level or thereabouts. That is precisely the problem. If we get rid of the unemployment, we're still going to have the deficit.

Senator HAWKINS. But even if we have the new high technology industries coming on line?

Mr. VOLCKER. They are taken account of in the economic projection. Let's assume all the high technology industries and all the other growth elements in the economy get our unemployment rate down to 6 or 6½ percent in 1986 or 1987. I hope you do something about this, but as things now stand, you're facing a $200 billion deficit or a $250 billion deficit in those years, and I've taken account of all the growth that you want to generate.

Senator HAWKINS. Even with the venture capital tax gains in 1978 and 1982?

Mr. VOLCKER. As the expenditure trends now stand and with growth of 4 or 5 percent a year for the next 3 or 4 years, you will end up with a deficit in the general magnitude of $200 billion.

Senator HAWKINS. If the growth were to exceed that——

Mr. VOLCKER. If the growth were 10 percent a year, I think you probably wouldn't have a deficit, but there's no reasonable prospect that the economy is going to grow at 10 percent for the next 5 years. We haven't got the capacity, manpower, or anything else. We have never grown at that rate of speed.

Senator HAWKINS. Thank you.

The CHAIRMAN. Senator Hecht, do you have any additional questions?

Senator HECHT. Mr. Chairman, my questions have been answered, not all to my satisfaction.

The CHAIRMAN. Well, that will never occur while you're in the Senate.

Mr. Chairman, let me just make a few observations in closing. There will be additional questions I'm sure by many of the members. I will have some additional ones, too, as I have not had the time to ask you all I wish to.

MAJOR PROBLEMS ARE POLITICAL—NOT ECONOMIC

We can discuss the short-term interest rates and my concern with them. But it's my feeling that having been here for 8 years and not being a professional economist or an amateur economist but simply looking at the economy in this country, it is my feeling that the ups and downs of the business cycle are political, not economic.

I say that because, as I observe what is going on right now, we have a tremendous desire on the part of Democrats to blame you and Ronald Reagan for the condition of the economy and we have a desire on the part of Republicans to blame past Democratic Congresses for the problem. It seems to me if we would look at the arithmetic—whether Republicans, Democrats, liberals, or conserva-

tives—that there are solutions that would create a long-term sustained recovery for this country. But we are just so damned interested in assessing blame in many cases just for selfish individual gain for the individual to look good for the next election. It seems to me we now are starting to panic. We are going to have a large jobs program just when we start coming out of a recession. I don't share your optimism about the economy sustaining over a period of time because of politics.

You look back at what Congress does in these situations and we come up with a big stimulus and it makes you feel good for a short period of time, certainly until the next election. Then you find you have just lighted that slow fuse that's going to light up another explosion. That isn't an opinion by J. Garn. It's a fact. You're hearing it from the press—you've got to do something.

I wish we could start taking longer term looks and be able to weather out some of these storms to flatten out that cycle a little bit. We are on the verge of that kind of panic once again just at the beginning of the recovery. Every jobs program I have seen since I've been here has been too late. If we're going to do jobs programs, we ought to do them at the beginning of recessions rather than at the end.

I think the major problem we have is politics: I also see us going through the phase again of "Let's get the military." I would agree completely with your statement that you shouldn't have military spending for the purpose of creating jobs, that spending ought to be determined on the basis of the threat. That is not being done in the Congress by the Republicans or Democrats either.

Now it's politically popular again to say let's save all social programs and cut the military; don't determine the level of spending on the basis of the threat. I'm one who thinks spending is below the threat. Looking at statistics, it was all right for John Kennedy to use 42 percent of his entire $106 billion budget to run the whole country for the military. But now Ronald Reagan's attempt, if he were to get every dime that he's asked for, he would spend 29 percent of the budget on the military. These numbers come from a very reliable source, a couple weeks ago a chart from the front page of the Washington Post. I think if people would objectively look at military spending, most of it is butter; 57 percent of it is for people, not for B-1's or jet airplanes or anything else. We've got a threat. A side benefit from military spending is jobs, and when you talk about cutting military spending $1 billion you eliminate about 35,000 jobs. Those people leave to go someplace. There may be more efficient ways to create higher number of jobs with $1 billion—I agree with that. But it certainly is true that a lot of those who lose their jobs from military spending cuts are going to go on unemployment rolls. There is a cost. Would you agree with that even though we both agree it isn't the most efficient way to create jobs, but the net effect of reducing our ability to deter the Soviet Union is an increase in cost in other areas, in unemployment benefits, welfare, other sorts of subsidy programs that must take care of those people?

Mr. VOLCKER. I think it's undeniable. If you reduce defense spending by x billion and then have a jobs program at the same x

billion you may not increase jobs on a net basis because you've got to lay off people in the jobs that are lost on the other side.

The CHAIRMAN. I don't know whether the net effect of a bill is a half billion or a billion dollars.

Mr. VOLCKER. I don't either.

The CHAIRMAN. The point is those who so politically preach to and leave this body—and hopefully some day we will return to a more representative citizen legislative body—and to simply attack the military budget and be unwilling to admit or at least portray the position that that is an entire savings, which simply is not the case at all, and those who will not admit that most of the military budget is butter—it may not be the highest quality butter, but it isn't weapons systems. You could eliminate the entire strategic weapons program and only eliminate 13 percent of the military budget and you can't save $15 billion in outlays in the 1984 budget. It doesn't exist. The only place you can get those kinds of savings is to eliminate people for operations and maintenance or fast spent out items that spend money in the near term. So then you are eliminating people to get those kinds of savings that people talk about to go back on other types of Government programs in order to take care of that cut.

I just wish there was some way to get people—if someone wants to come to me and say, "Jake Garn, I disagree with your assessment of the threat. We can cut military spending this much," that's fine. That's a different opinion on the assessment of the threat. But to indicate you get all these savings from the military budget and it doesn't imply some increased cost in other areas of the Government is simply not telling the truth or looking at the arithmetic of that budget and the real growth item in the budget over the last 20 years has dramatically been—totally apart from political philosophy—has been in the social programs and primarily the transfer payments, but we haven't got enough guts to talk about that. We're going to get the military and hope the Russians turn the other cheek and hope that Mr. Andropov turns out to be a real nice guy, protective, benevolent and doesn't continue to use poison gas and other things in Afghanistan.

Well, I'm going far, far afield from the purpose of this hearing to discuss monetary policy. It seems to me if we once again forget partisan politics, you simply cannot ignore the impact of the $1,303 billion national debt created under both Republican and Democratic Presidents and with the approval of both Republic and Democratic Members of the House and Senate for a period of three decades and interest on the national debt of $125 billion this year. We talk about debts of $200 billion. If we hadn't been spending excessively—to make the point about fiscal policy being the prime culprit in this—if we hadn't all these years been spending far more than we take in, we'd be pretty darned close to a balanced budget without having that $125 billion interest on the national bill. That's a fact, isn't it? May the record show that the nod was a yes.

Mr. VOLCKER. Yes.

The CHAIRMAN. Again, in closing, let me express my frustration at the inability of politicians of both political parties, liberals and conservatives alike, to face the real problem, the fiscal policy of this country is the primary driver of these high interest rates and

the high unemployment and my opinion is that has to be it. There are other factors, but that has to be at a minimum 75 percent of the problem, and until we in both parties quit looking for scapegoats and try to gain our own political gain—I don't share the optimism of you and some of the others. Until we can solve the political problem, I don't see how we can solve the economic problem and my colleagues in both parties may be rather surprised that the best politics is doing what is right. They may be amazed at the margins they would achieve in their reelection bids if they had the courage to look at these numbers and do something about fiscal policy, because I would submit you wouldn't be very well known in this country or the Federal Reserve would not be very well known because you wouldn't have very much to do. Achieving your monetary targets would be relatively easy and you would be a quiet agency in the background.

Mr. VOLCKER. I agree with you on that. You know, I do feel optimism, but I would simply conclude by saying the first qualification to my optimism and the first threat and first obstacle is the deficit problem.

The CHAIRMAN. And I suppose if I could do one thing—and I have said this many times—one thing more to solve this problem for future generations more than anything else is a constitutional amendment to amend the terms of the President to 6 years so he could really be a statesman, and Senators and Representatives to for 3 to 4 years and send us all home. Howard Baker—and I agree with his philosophy about a citizen legislative body. We do not have that. We have a growing tendency of making our livings, our entire lifetime—much as I hate to see Howard Baker go because of his great leadership, boy, do I admire his courage to practice what he preaches and to leave this body and hopefully some day we will return to a more representative citizen legislative body that doesn't desire to be professional politicians perpetuating themselves in office until they're 90 or 95 years old.

Mr. Chairman, thank you very much for your patience and we look forward to seeing you tomorrow before the International Finance Subcommittee.

The hearing is adjourned.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[The report from the Federal Reserve Board follows:]

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 16, 1983

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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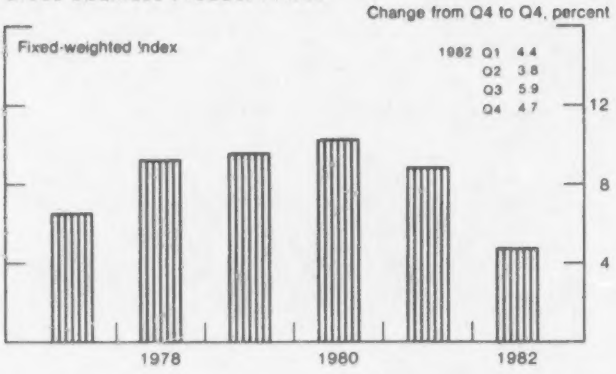
Section 1: The Performance of the Economy in 1982

The recession that began in mid-1981 continued through 1982, bringing the cumulative decline in real gross national product over that period to 2-1/2 percent. Unemployment reached a postwar high, while industrial capacity utilization fell to a postwar low. At the same time, however, inflationary pressures were greatly reduced; and while some potential obstacles to growth clearly need attention, an economic environment conducive to sustainable recovery and expansion seemed to be emerging by year-end.

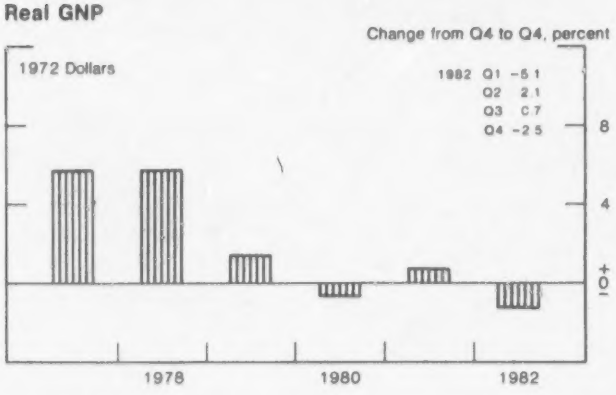
To a considerable extent, the recession and its attendant economic and financial stresses have reflected the difficulties inherent in reversing an inflationary trend that had been gaining momentum for more than a decade. By the late 1970s, the underlying inflation rate had accelerated to near the double-digit level, and expectations of rising wages and prices had become deeply embedded in the behavior of consumers, businesses, and investors. Growing financial dislocations and economic imbalances made it plain that inflation was having a debilitating effect on our economic performance. Although policies to curb the inflation were strengthened considerably in late 1979, the inflation rate remained quite high through 1980 and slowed only a little in 1981.

In this past year, however, the progress against inflation has been more dramatic. The rate of increase in most price measures in 1982 was only a third to half the peak inflation rates of 1979 and 1980, a much faster deceleration than had generally been thought possible when the year began.

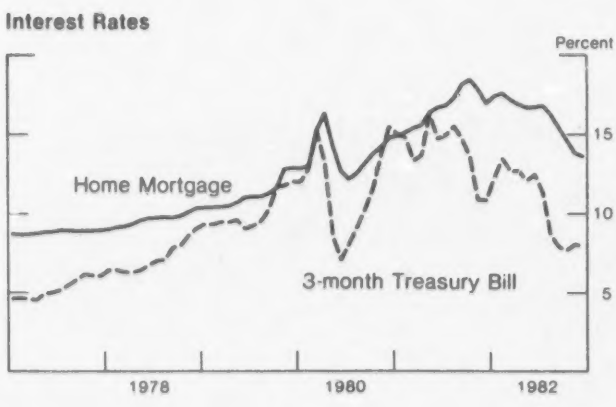
Gross Business Product Prices



Real GNP



Interest Rates



The slowdown was attributable to temporary influences to some extent, but there also has been more fundamental progress. In particular, expectations of inflation are being scaled down, productivity is improving, and there are widespread indications of business and labor adapting their price and wage practices to the competitive realities of a new, less inflationary environment.

Reflecting both the sharp deceleration of price inflation and the cutbacks in economic activity, nominal GNP grew only 3-1/4 percent over the four quarters of 1982, little more than a third the rate of growth in 1981. Nevertheless, the demands for money remained quite strong, as exceptional economic and financial uncertainties bolstered investors' desires to hold liquid balances, and as the attractiveness of depository accounts was enhanced by the progressive liberalization of deposit rate regulations.

The growth in aggregate debt outstanding also was quite strong, with a particularly steep increase in the credit needs of the federal government. Federal borrowing was extraordinarily large in the second half of 1982, when the federal sector absorbed nearly half of the funds raised by all domestic nonfinancial borrowers. State and local governments, too, issued substantial amounts of new debt in 1982, especially late in the year. Private credit demands, however, were curtailed sharply as economic activity weakened.

Interest rates fell appreciably in 1982, primarily in the second half. By the end of the year short-term rates were about half the peak levels of 1981, and long-term rates also had declined considerably. In turn, the declines in rates helped trigger an improvement in activity toward year-

end in the credit-sensitive sectors of the economy. In particular, automobile sales have perked up in recent months, and an upturn in the housing sector gained momentum as the year progressed. Following an exceptionally rapid liquidation of business inventories in the fourth quarter, the pressures to reduce stocks appeared to be easing early in 1983 as both production and employment increased in January. All told, these and other recent data provide strong indications that recessionary forces are dissipating and that the economy may be entering the initial phases of a new expansion.

Interest rates. A year ago, as 1982 began, interest rates were moving higher in association with stronger demands for money and credit, reversing a portion of the decline that occurred as the economy slipped into recession in the second half of 1981. However, the rise in rates was soon halted. Short-term interest rates showed little net change from late January through June, and then fell sharply in the third quarter, as sluggish money growth through the early part of the summer reduced the demand for bank reserves, easing pressures in money markets. With market rates falling and the economy still quite sluggish, the Federal Reserve reduced its discount rate by 3-1/2 percentage points over the second half of the year in seven separate steps, thereby accommodating the downward movement in money market rates. During this period, the broader monetary aggregates were running at or just above the annual target ranges, but this did not seem inappropriate in light of prevailing economic and financial conditions. By December short-term rates had fallen around 5 percentage points from their average levels in June.

Long-term interest rates also registered substantial declines in the second half of the year, responding not only to the easing in money markets, but also to the sustained moderation of inflation and weakness in economic activity. On balance, yields on bonds and conventional mortgages fell 3 to 4 percentage points between June and December. The decline in long-term yields and the promise of a sustained pickup in economic activity helped to maintain a sharp rise in stock prices beginning in the summer, with several broad market indexes reaching historic peaks late in the year and rising to still higher levels in early 1983.

In addition to the general cyclical factors affecting interest rates, the structure of rates across different markets this past year reflected, to an unusual degree, investor concerns about the financial health of borrowers. Severe stress was evident in a high level of bankruptcies, as well as in other difficulties experienced by many businesses and financial institutions in the U.S. and abroad. In these circumstances, lenders began to assess credit risks more carefully, demanding larger returns for extending credit to potentially troubled borrowers. Later in the year, however, these risk premiums dropped to more normal levels as an easing of overall credit conditions and anticipations of a pickup in economic activity relieved some of the anxieties in financial markets.

Even with the sharp declines of 1982, interest rates remain at high levels relative both to their historical levels and to current inflation rates. A major factor propping up longer-term rates especially is the prospective size of federal government deficits, which threaten to remain massive even as the economy recovers, thereby competing with the rising

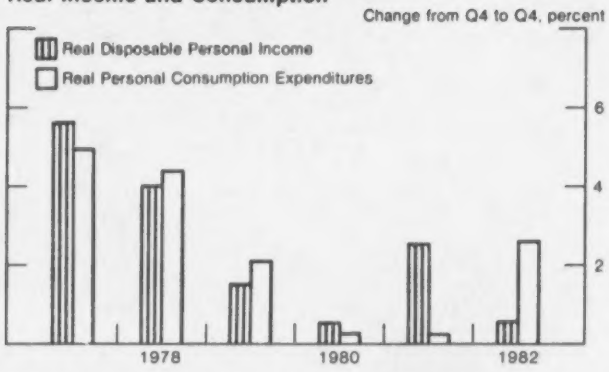
demands of private borrowers for available savings. Moreover, although inflation moderated substantially in 1982, many potential investors, scarred by the experience of the 1970s, remained cautious about the longer-range outlook--and about the government's commitment to maintain forceful anti-inflationary policies.

Residential construction. So far, the housing sector has been the main beneficiary of falling interest rates. A gradual upturn in housing activity that began in late 1981 gained momentum in the second half of 1982 as mortgage rates moved sharply lower. By last month the interest rate on commitments for conventional fixed-rate mortgages had dropped to 13 percent from a high of 18-1/2 percent in the fall of 1981, and rates on many types of variable rate loans had declined even more.

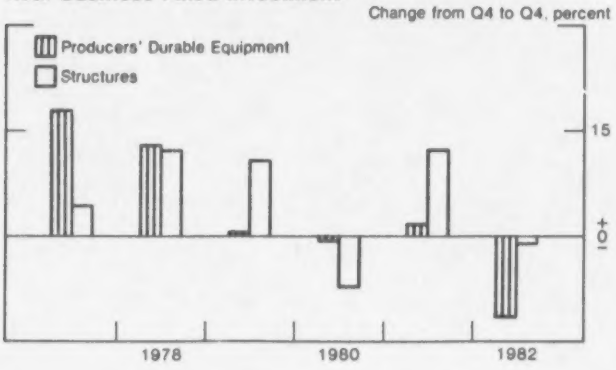
Homebuyers responded favorably to the rate reductions, and in the fourth quarter, sales of both new and existing homes rose to their highest levels since the recession began in mid-1981. Because the inventory of unsold new homes had been drawn down to a low level, the improvement in sales in the second half provided a direct impetus for new construction activity. Starts of new single-family dwellings in the fourth quarter were up almost 50 percent from depressed year-earlier levels, with most of that gain coming in the second half of the year. Starts of new multi-family units rose through most of the year, supported in part by federally-subsidized units.

Consumer spending. Consumers continued to exhibit cautious spending patterns through most of 1982. Despite sharp reductions in personal tax liabilities at mid-year, real after-tax income rose only .6 percent during the year, as reductions in employment cut deeply into wage and salary

Real Income and Consumption



Real Business Fixed Investment



Total Private Housing Starts

payments. At the same time, consumers were reluctant to finance purchases by taking on new debt. Domestic auto sales remained depressed through most of the year, with the pace for 1982 as a whole the worst in more than two decades. Foreign car sales also fell, but much less than sales of domestic makes.

Nevertheless, the economic situation in the consumer sector appeared to be improving as the year ended. With liquidity up and debt burdens down, consumers' financial positions, in the aggregate, have improved considerably from the over-extended positions of the late 1970s. Consumer confidence began to perk up in the second half of 1982 as inflation remained moderate and as interest rates on consumer loans began gradually to decline. Spending, most notably on durable goods, started to grow more rapidly toward year-end. Sales of domestic autos rose significantly in November and have been maintained at a higher level into early 1983, apparently reflecting financing concessions as well as changes in manufacturers' design and pricing policies. Retail sales excluding autos also rose a little in late 1982, and in the fourth quarter, total consumer spending registered its strongest gain, in real terms, since late 1980.

Business sector. The persistent weakness of economic activity in 1982 led to considerable stress in the private business sector. Among nonfarm businesses, low operating rates depressed corporate profits, and the financial condition of many firms weakened under the burden of reduced availability of internal funds, heavy short-term indebtedness, and high interest charges. Credit ratings deteriorated for many businesses, the incidence of dividend reductions or suspensions increased, and business bankruptcies rose to a postwar high.

Signs of growing financial distress also were evident in the farm sector of the economy. Because of weak demand and exceptionally large crop harvests in 1982, farm prices slumped and income was low for the third year in a row. Land prices in the farm sector have fallen substantially in some areas since mid-1981, farm proprietors' equity has declined, and debt-to-asset ratios have risen noticeably in the past two years. Difficulties in servicing debt have increased, especially among those farmers who came to rely more heavily on credit financing in earlier years, and farm bankruptcies and foreclosures have become more numerous.

Confronted with weak demand and financial strains, many business firms moved aggressively in 1982 to trim inventories and curtail capital spending. In real terms, total fixed investment expenditures in the business sector fell more than 8 percent over the four quarters of 1982. Cutbacks in spending for equipment accounted for nearly all of the decline; purchases fell especially rapidly for heavy industrial machinery such as engines, construction equipment, farm machinery, and transportation equipment.

Business investment spending on nonresidential structures slowed in the first half of 1982 and then turned down in the second half. Much of the decline was concentrated in outlays for oil and gas drilling, which fell sharply over the year as drilling incentives weakened in response to worldwide reductions in energy demand and declines in petroleum prices. In contrast, business spending for new buildings was well maintained through 1982, although part of this strength probably reflected the continuation of projects started some time ago. Forward-looking indicators, such as the

constant-dollar value of new construction contracts, fell substantially during the year while vacancy rates for office buildings climbed sharply. These and other indicators suggest that capital spending by businesses, especially for construction, could continue to weaken for some months.

Depressed aggregate demand also caused businesses to liquidate inventories at a rapid pace in 1982. The weakening of final sales in the second half of 1981 had led to an unintended buildup of inventories, and in early 1982 businesses began liquidating those excess stocks at a rapid pace. However, the runoff of inventories halted around mid-year, possibly because businesses generally anticipated a midyear upturn in sales. When no such upturn occurred, a second round of inventory liquidation began, and stocks were reduced at a particularly rapid pace in the fourth quarter. By year-end many industries had reduced inventories to below pre-recession levels, but stocks in some sectors still appeared large relative to the prevailing sales pace.

Reflecting the reductions in inventories and capital spending, businesses reduced their credit usage appreciably in 1982. The strong rally in the stock market that began during the summer also helped reduce borrowing, as firms started relying more heavily on equity financing and relatively less on new debt issuance. Falling long-term interest rates enabled businesses to accomplish some lengthening of their debt maturities toward the end of 1982, but even so, business balance sheets at year-end were heavily laden with short-term debt.

Government sector. Total government purchases of goods and services rose 2-1/2 percent in real terms during 1982, about the same increase as in the previous year. At the federal level, real outlays for national defense

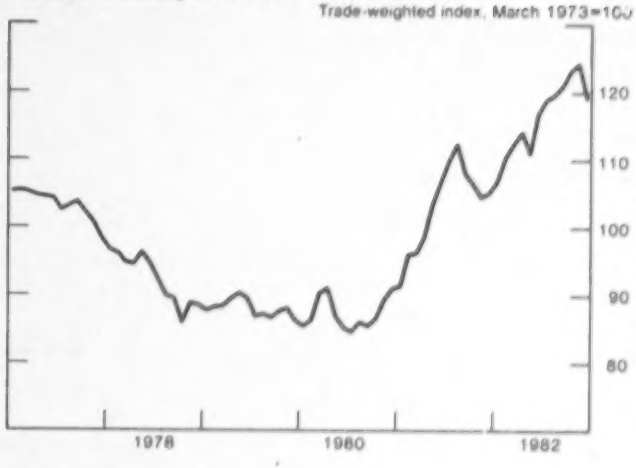
expanded rapidly for the second year in a row. Spending also rose considerably for agricultural programs, as the federal government accumulated farm inventories under programs designed to keep farm prices and farm incomes from falling further. Federal purchases of other goods and services, on balance, were cut back sharply.

The credit demands of the federal government rose steeply in 1982, and accounted for almost 40 percent of total credit flows to the domestic nonfinancial sectors of the economy. Federal borrowing from the public rose from $87 billion in 1981 to $161 billion in 1982, as the federal deficit widened in response to weak growth in taxable incomes, reductions in tax rates, the further rise in government purchases, and a recession-induced increase in unemployment compensation and other transfer payments.

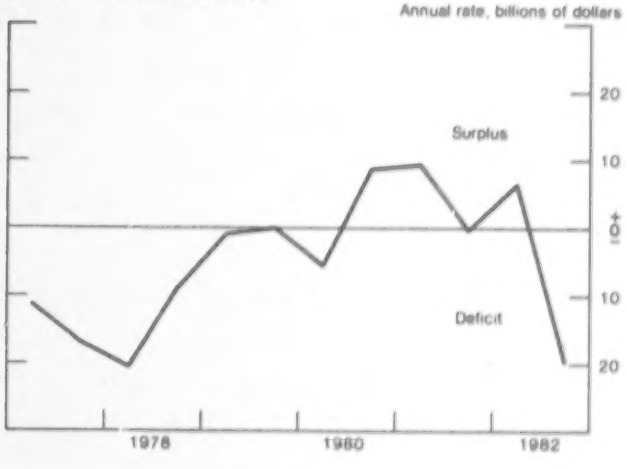
Real purchases of goods and services by state and local governments were little changed over the four quarters of 1982. Faced with a recession-induced shrinkage in tax revenues and cutbacks in federal support, many state legislatures enacted increases in sales, income, or corporate taxes to help maintain service levels. In addition, state and local borrowing increased substantially, not only to finance traditional functions but also, in a number of cases, to support mortgage lending in local communities. A surge in new bond issues in the fourth quarter was in part an attempt by state and local governments to raise funds before a requirement to register all new issues of tax-exempt securities after year-end (later postponed to mid-1983) was scheduled to take effect.

International payments and trade. Following a steep advance in 1981, the weighted-average value of the dollar appreciated another 20 percent from

Foreign Exchange Value of the U.S. Dollar



Current Account Balance



Note Current account balance for 1982 H2 is partially estimated by the Federal Reserve Board

the beginning of 1982 through early November. The strengthening apparently was in large part a response to the progress made in reducing inflation and the sense of a continuing commitment of U.S. authorities to ensure greater economic stability. Moreover, during a period of major strains in the international financial system and considerable economic uncertainty there evidently was a view that dollar assets, especially U.S. assets, would provide a "safe haven". Since early November the foreign exchange value of the dollar has fallen a little, on net, as market participants have reacted to the prospect of very large deficits in 1983 in the U.S. merchandise trade and current accounts.

A movement towards deficit in the U.S. current account was already evident in 1982. Reflecting the effects of the strong dollar, as well as sluggish economic growth abroad, real exports of goods and services decreased 13 percent over the four quarters of 1982. The volume of imports of goods and services also declined during 1982, but the decline was smaller than for exports; the increasing price competitiveness of foreign goods, which resulted in part from the strong dollar, helped support import demand. As a result of these trade patterns, net exports, in real terms, fell $15 billion over the four quarters of 1982; the trade sector thus made an atypically large contribution to the recession. The U.S. current account, which was in small surplus for 1981 as a whole, recorded surpluses in the first half of the year but then swung into deficit in the second half as exports weakened.

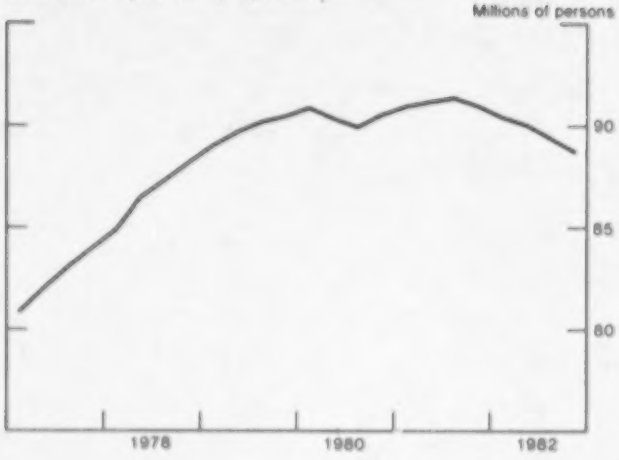
The external financial position of several large borrowing countries --notably Argentina, Brazil, and Mexico--worsened in 1982. These financing problems have placed severe strains on the banking system and on international

markets generally, as the need arose to refinance or reschedule existing debt. During the year there were repeated cooperative efforts among borrowers and private and official lending institutions to address these problems, and the debtor countries, to gain control of rising debt burdens, are adopting strong policies of internal and external adjustment. As a result, there has been a reduction in their demand for exports from major industrial countries, particularly the United States because of its close ties to Latin America.

Labor markets. Employment in the United States fell steadily throughout 1982, and by year-end total nonfarm payroll employment was more than 2-3/4 million below its July 1981 peak. As is typical in recessions, the largest job losses were in the cyclically sensitive manufacturing and construction industries. In addition, employment fell in the oil and gas drilling industries, and trade employment suffered an unusually sizable decline. Employment in the service sector continued to grow in 1982, but at a slower pace than in recent years.

The back-to-back recessions of the early 1980s were accompanied by a rise in total unemployment of about 5-1/2 million, and by the end of 1982, the unemployment rate, at 10.8 percent, was nearly two percentage points above its previous postwar peak. Increases in unemployment were especially large among adult men, who hold a disproportionate number of jobs in the cyclically sensitive industries. As the recession persisted through 1982, the number of workers unemployed for longer than a half-year increased to more than 2-1/2 million. To support the incomes of these long-term

Nonfarm Payroll Employment



Unemployment Rate

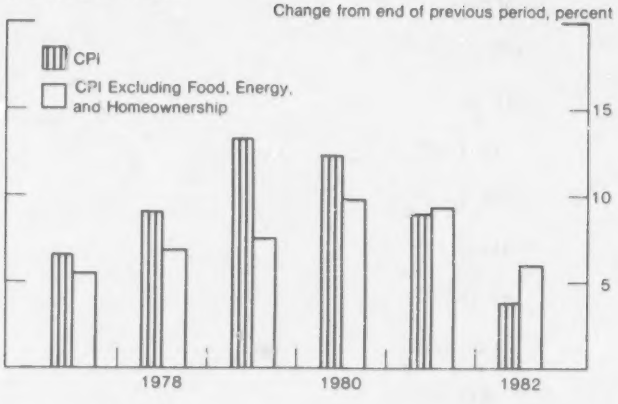
unemployed, the period of eligibility for unemployment benefits was lengthened twice, to as much as 55 weeks for some workers.

Nevertheless, a little improvement in labor demand began to be evident around the turn of the year. The incidence of layoffs appeared to be moderating toward the end of 1982; unemployed workers have been recalled in some industries. And in January of this year, the civilian unemployment rate declined to 10.4 percent.

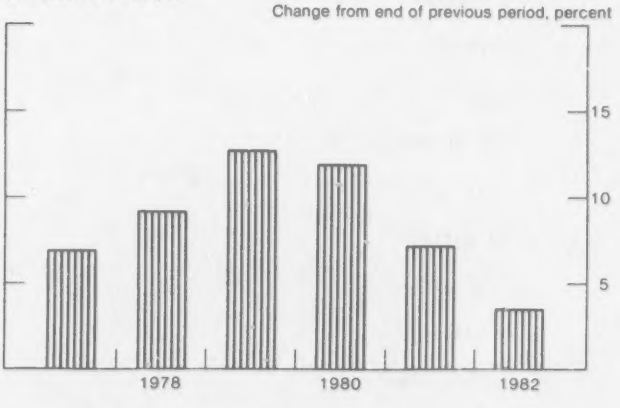
Wages and labor costs. The falloff in labor demand in 1982, along with the general unwinding of inflation, led to a sharp slowing in the rise of wages and labor costs. The wage rates of production workers increased about 6 percent during 1982, the smallest advance in 15 years. The moderation in wage increases was especially striking among new contracts negotiated under major collective bargaining agreements; in 1982, first-year wage increases under these agreements averaged 3-3/4 percent, less than half the average increases reached when these workers last negotiated. In some particularly hard-pressed industries, workers agreed to new contracts that eliminated altogether the fixed wage increases that had been customary in past wage agreements, and in some cases there were outright wage reductions. Nevertheless, with price inflation slowing even more rapidly than nominal wages, real wage rates in the nonfarm business sector actually rose faster than in most recent years.

Labor costs per unit of output were up only 4-1/2 percent over the four quarters of 1982, as an improved productivity performance reinforced the impact of slower nominal increases in wages and benefits. Qualitative reports throughout the year suggested that business firms, many of them

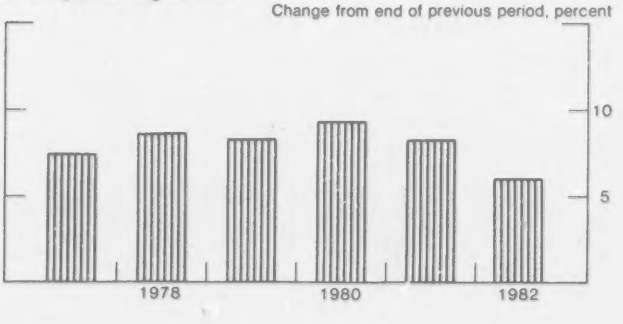
Consumer Prices



Producer Prices



Hourly Earnings Index



hard-pressed financially, were engaged in aggressive efforts to cut costs and bolster efficiency. Productivity gains in the second half of the year were particularly noteworthy, given that business output was still declining cyclically; normally, productivity tends to slump in the contraction phase of the business cycle as firms reduce output by more than hours worked.

Prices. In 1982, all major price indexes advanced at considerably slower rates than in 1981, and for some price measures, the increases in 1982 were the smallest in more than a decade. The consumer price index rose 3.9 percent over the year, compared to a 12-1/2 percent advance just two years earlier. Capital goods prices were up less than half as much as in 1981, and prices were little changed for a broad range of materials used in manufacturing and construction.

In many ways the slowing of inflation this past year has reflected the pervasive influence of the recession on product and labor markets. In addition, the strength of the dollar has helped to hold down the prices of U.S. imports; bountiful harvests have contributed to declines in agricultural prices; and the worldwide recession has depressed the prices of oil and other commodities. Although these influences themselves may prove to be temporary, the foundation is now in place for more lasting gains against inflation. In particular, the wage-price interactions that served to perpetuate inflation through the 1970s appear to have lost much of their momentum. Workers generally are agreeing to smaller pay increase than in earlier years, and in some sectors in which long-term wage agreements are prevalent, the settlements concluded in 1982 will help ensure diminished labor cost pressures in coming years. Lower labor costs are relieving

pressures on prices, and, in turn, an improved price performance is reducing expectations of inflation and thus leading to a further slowing of labor costs. This cumulative process of disinflation still appeared to have momentum at year-end, thereby providing solid grounds for continuing better price performance in 1983.

Section 2: The Growth of Money and Credit in 1982

The Federal Reserve has been seeking to provide enough liquidity to facilitate an early upturn in economic activity, while maintaining the monetary discipline needed to sustain the progress toward lower rates of inflation--a crucial element in satisfactory economic performance over the longer run. The specific monetary target ranges chosen by the Federal Open Market Committee last February and reaffirmed in July were as follows, with growth measured from the fourth quarter of 1981 to the fourth quarter of 1982: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The associated range for bank credit was 6 to 9 percent at an annual rate, measured from the average level of December 1981 and January 1982 to the fourth quarter of 1982; the base period for bank credit was selected to minimize distortions from the shifting of assets to newly established International Banking Facilities, first authorized in late 1981.

It was recognized when selecting these ranges that several factors could affect the relationship of monetary and credit growth to income and expenditure in the economy. In particular, the Committee contemplated that M1 might deviate for periods of time from expected patterns of growth in the event that economic and financial uncertainties fostered unusual desires for liquidity. Such desires had already been indicated by a surge in growth around year-end 1981, at which time it was believed that vigorous efforts to bring money back within target ranges rapidly would not be appropriate when the economy was still quite weak. In addition, the demand for M1 was seen as likely to demonstrate a continuing sensitivity to changing financial technology and the proliferation of new money and near-money type instruments. The Committee

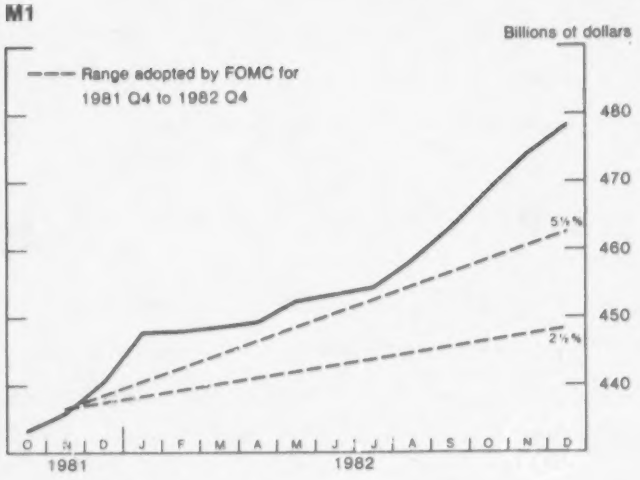
also anticipated that the broader aggregates, M2 and M3, might be affected by legislative and regulatory changes, such as broadened eligibility for Individual Retirement Accounts (IRA) and Keogh accounts and the ongoing deregulation of deposit rates, as well as unusual desires for liquidity. In July, while the Committee decided to retain the ranges adopted earlier for monetary growth, it underscored in its report to the Congress its willingness to accommodate any unusual precautionary demands for liquidity that might be associated with unsettled economic and financial conditions.

The behavior of the aggregates over the year indeed diverged substantially from normal historical patterns. Precautionary motives evidently boosted demands for money and other highly liquid assets relative to the expansion of nominal GNP, which remained quite sluggish. M1 expanded 8-1/2 percent on a fourth-quarter to fourth-quarter basis, 3 percentage points above the FOMC's target range, largely reflecting relatively rapid growth over the course of the year in interest-bearing checking accounts that also serve a savings function. In addition, M1 growth was boosted by special developments late in the year in connection with the large amounts of maturing all savers certificates.

The broader aggregates, M2 and M3, expanded at rates of 9.2 and 10.1 percent, respectively, much closer to--though still somewhat above--the upper limits of their ranges. These growth rates for M2 and M3, it should be noted, are lower than those observed prior to some recent changes in money stock definitions, the previous figures being 9.8 and 10.3, respectively. To maintain consistency in the treatment of various kinds of financial assets, M2 and M3 now include balances in tax exempt money market mutual funds, which

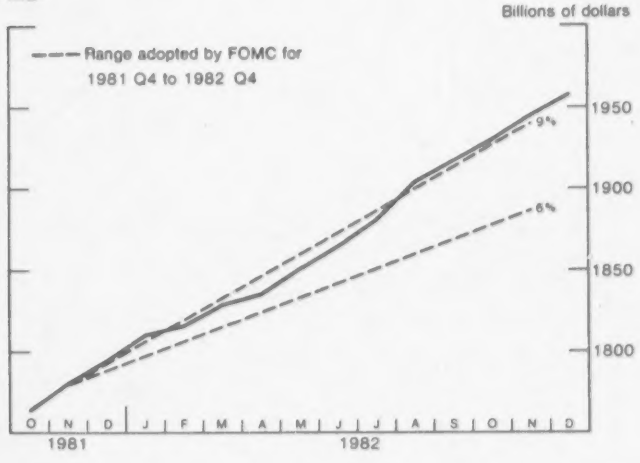
FOMC Ranges and Actual Growth

M1



Rate of Growth
1981 Q4 to 1982 Q4
8.5 Percent

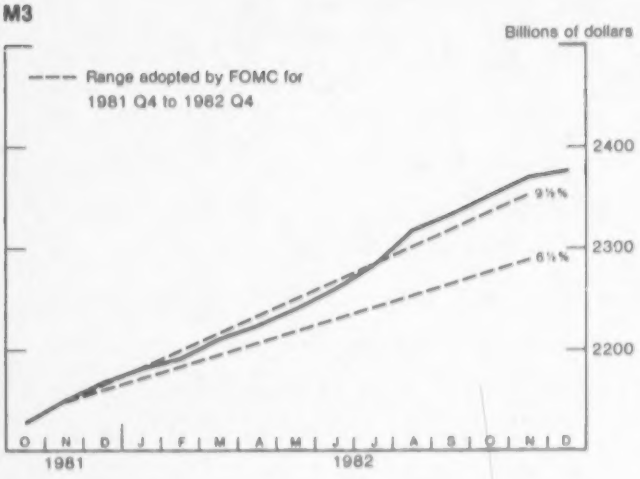
M2



Rate of Growth
1981 Q4 to 1982 Q4
9.2 Percent
(Prior to redefinition, 9.8 percent)

FOMC Ranges and Actual Growth

M3



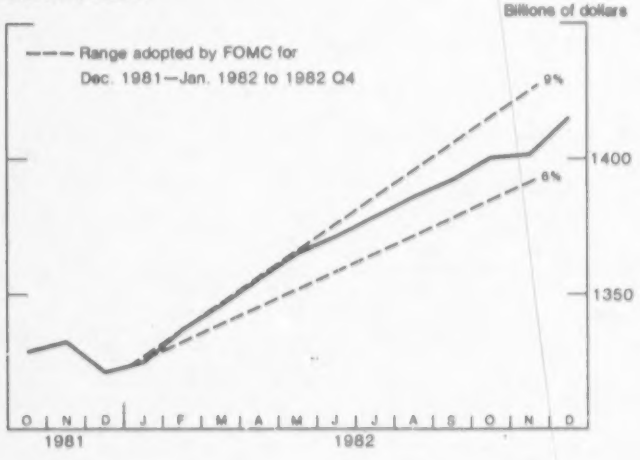
Rate of Growth

1981 Q4 to 1982 Q4

10.1 Percent

(Prior to redefinition, 10.3 percent)

BANK CREDIT



Rate of Growth

Dec. 1981—Jan. 1982 to

1982 Q4

7.1 Percent

have attributes very similar to those of the highly liquid taxable money funds, and exclude balances in IRA and Keogh accounts, which closely resemble pension funds and consequently are much less like money balances. The table on page 18 shows figures for M2 and M3 growth in recent years under both old and new definitions.

The income velocity of various measures of money--defined as the ratio of gross national product to measures of money--fell sharply in 1982. The velocity of M1 dropped 4-3/4 percent and that of M2 5-1/2 percent, from the fourth quarter of 1981 to the fourth quarter of 1982. For M1, this was the largest four-quarter decline in the postwar period, and in fact there have been very few four-quarter spans in which M1 velocity declined at all. In the case of M2, no parallels for the steep velocity decline of last year are to be found since the 1950s.

Although declines in velocity of M2 have not been uncommon during periods of recession, in past periods they were explainable largely in terms of reflows of funds from securities into M2-type balances when market rates of interest fell below deposit rate ceilings--a factor of much reduced importance in the present regulatory environment and with the emergence of money market mutual funds as an important investment outlet. The recent weakness in velocity more probably reflects strong demands for relatively safe, liquid assets on the part of the public because of uncertainties in the business and financial outlook.

Further evidence of strong precautionary demands is to be found in the particular types of monetary assets that the public chose to acquire last year. Interest-bearing NOW accounts--which are included in M1--continued to expand rapidly, though growth was, of course, less rapid than in 1981 when they first

GROWTH OF MONEY AND CREDIT
(Percentage changes)

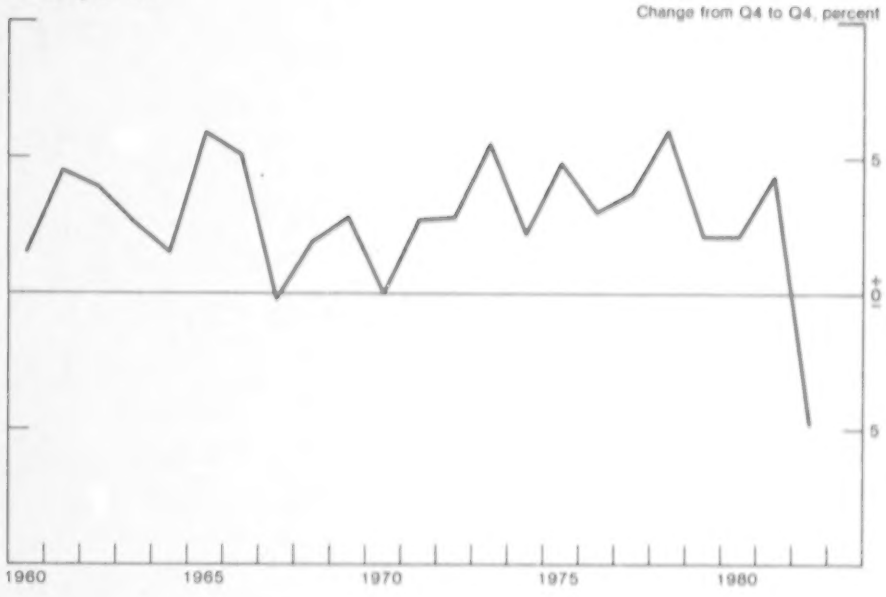
	M1	New M2	Old M2	New M3	Old M3	Bank Credit[2]	Outstanding Debt of Domestic Nonfinancial Sectors
Fourth quarter to fourth quarter							
1978	8.2	8.0	8.2	11.1	11.3	13.3	12.9
1979	7.4	8.1	8.4	9.6	9.8	12.6	12.1
1980	7.2	9.0	9.2	9.7	10.0	8.0	9.9
1981	5.1 (2.5)[1]	9.4	9.5	11.7	11.4	8.1	9.9
1982p/	8.5	9.2	9.8	10.1	10.3	7.1	9.5
Annual average to annual average							
1978	8.2	8.5	8.8	11.5	11.7	12.4	12.2
1979	7.7	8.2	8.5	10.2	10.3	13.6	13.1
1980	6.2	8.0	8.3	9.0	9.3	8.6	12.3
1981	7.2 (4.8)[1]	9.5	9.8	11.6	11.6	9.4	10.0
1982p/	6.5	9.4	9.8	10.5	10.5	5.8	10.0

p - Preliminary
1. M1 figures in parentheses are adjusted for shifts to NOW accounts in 1981.
2. Bank credit data are not adjusted for shifts to International Banking Facilities in 1981 and 1982. The 1982 growth rate, however, is calculated from a December 1981 and January 1982 base to minimize distortions owing to such shifts.

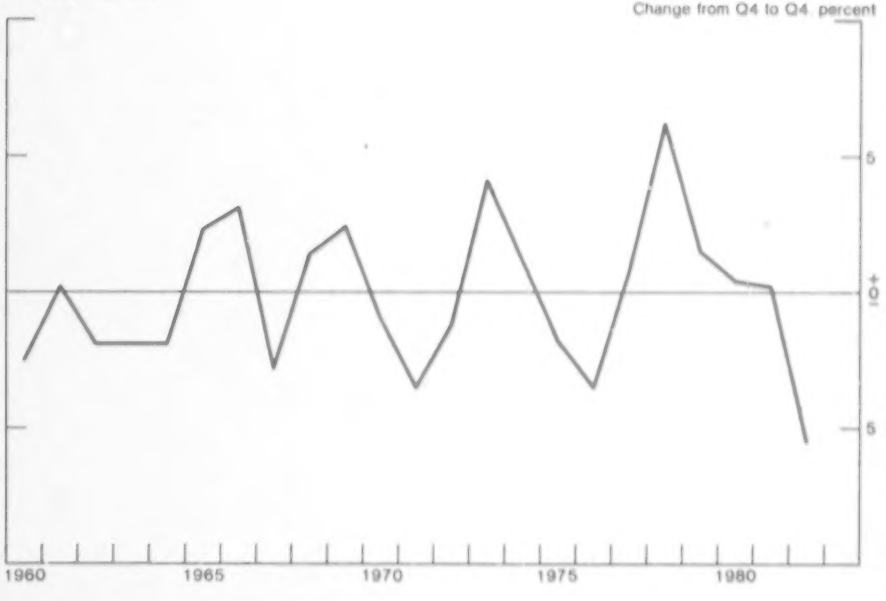
NOTE: M1 and the new M2 and M3 figures incorporate minor effects of benchmark and seasonal adjustment revisions. New M2 and M3 incorporate definitional changes as well.

Growth in Velocity*

Velocity of M1



Velocity of M2



* Velocity equals GNP divided by M1 or M2

became available nationwide. Such deposits, while serving the transactions needs of holders, have many of the characteristics of savings accounts, which in the past have tended to grow during periods of economic adversity. Indeed, during the first half of last year, when interest rates on other investments were still relatively high, individuals began once again to add to their savings balances following a long downtrend in such deposits; growth in savings deposits surged once more in the final months of 1982, apparently buoyed in part by deposits of proceeds from maturing all savers certificates. The attractiveness of NOW and savings accounts no doubt was enhanced after midyear as lower interest rates reduced the earnings disadvantage of keeping funds in such highly liquid form. Other types of liquid assets included in the aggregates also grew rapidly in 1982. There was a sizable buildup of balances in the 7- to 31-day accounts and 91-day accounts at depository institutions, soon after these accounts were authorized in May and September, respectively. Shares of money market mutual funds also increased substantially, albeit much less rapidly than in 1981 when many people were first attracted to these savings vehicles. By contrast, inflows to longer-maturity time deposits were moderate.

The apparent strong desire for liquidity, and the associated shifting in asset demands, had an important bearing on the FOMC's assessment of the behavior of the aggregates as the year progressed. The Committee felt that some growth in the aggregates above the longer-run target ranges could be tolerated in the prevailing economic conditions which appeared to be giving rise to greater precautionary demands for money than might be anticipated in normal circumstances. The lengthening recession and associated economic dislocations prompted more cautious financial management on the parts of households

and businesses, and this attitude of caution in financial markets was intensified from time to time by concerns about strains on some financial institutions and about the ability of private and governmental borrowers in a number of foreign countries to meet their debt-service obligations. The latter part of the year, moreover, brought a number of institutional developments that further complicated the interpretation of the movements in the money supply, necessitating a more than ordinary degree of flexibility in responding to incoming data on monetary growth.

It was recognized in the early fall that the behavior of M1 during the final three months of the year would very likely be distorted by special factors. In particular, an extremely large volume of all savers certificates matured beginning in early October, and this was expected to have sizable temporary effects on M1. Also of potential importance was the introduction (mandated by the Garn-St Germain Depository Institutions Act of 1982) of new deposit instruments for banks and thrift institutions that were to be competitive with money market mutual funds. In the event, the Depository Institutions Deregulation Committee authorized, beginning December 14, depository institutions to offer a "money market deposit account" (MMDA) that could be used to a limited extent for transactions purposes and that would be free from interest rate ceilings, and authorized Super NOW accounts free of interest rate ceilings beginning January 5.

MMDAs, because of their more limited transactions feature, are included only in the broader aggregates, while Super NOWs, which have unlimited transactions features but also include a savings element, are included in M1. Clearly, these distinctions are not clear-cut, and they illustrate the

increasing fuzziness of the dividing line between M1 and non-M1 type balances. In fact, in making this definitional decision, the Federal Reserve Board noted that it would be monitoring carefully the behavior of the new accounts to determine whether some alteration in their treatment might be advisable.

The sizable fund shifts that might result from these developments in the fourth quarter--and, in the case of the new accounts, possibly even shifts in anticipation of their availability--seemed likely to have direct and indirect effects on M1 that would be large in magnitude and would, particularly in the case of the new accounts, affect the underlying behavior of narrow money as the public reallocated transactions and savings funds. As a result, the FOMC at its October meeting decided that it would give considerably less weight to M1 in the conduct of policy and rely more on the broader aggregates, M2 and M3. It was anticipated in this decision that the special factors affecting M1 growth in the fourth quarter would have a much smaller impact on M2 and M3 since a major portion of the shifts of funds would occur among assets contained in these broader aggregates; for example, proceeds from maturing all savers certificates (a component of M2) that were deposited in transactions balances would remain part of M2. However, it was recognized that the advent of the MMDA might boost M2 expansion late in the year.

In late December, M2 growth in fact was raised by sizable inflows to MMDAs from sources outside M2--such as market instruments and large CDs--and growth continued at an extraordinarily rapid pace into the early weeks of 1983. The new accounts were heavily advertised by the depository institutions, and often were offered initially at interest rates that were exceptionally

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high relative to prevailing rates on comparable investments. By year-end, MMDAs outstanding had risen to a level of about $87 billion, and by the end of January 1983 were about $230 billion. Super NOW account growth was much slower, reaching about $18 billion by the end of January.

Commercial bank credit grew 7.1 percent in 1982, near the midpoint of the FOMC's range. The pace of bank loan growth during the year was considerably affected by changes in the pattern of business financing. During the first half, when the persistence of high long-term interest rates encouraged firms to concentrate their borrowing in short-term markets, business loans at banks expanded rapidly. But as interest rates moved lower over the second half, corporations increasingly shifted their financing to long-term debt and equity markets; in the third quarter business loan growth slowed sharply and in the fourth quarter showed no net increase, as corporations used the proceeds from bond sales to avoid increasing bank indebtedness. Real estate loans at banks also slowed as the year progressed and, for the year as a whole, increased only 5-1/2 percent--a rate below that of recent years. Consumer loans continued weak, expanding only 3-1/2 percent. While loan growth slowed, banks greatly expanded their holdings of U.S. Treasury obligations during the year, acquiring close to $13 billion in the final quarter alone.

Section 3: The Federal Reserve's Objectives for the Growth of Money and Credit

The economy over the past year and a half has passed through a most difficult period, one of high unemployment, depressed incomes, and severe distortions in financial markets. There is substantial evidence that the recession is ending. Forces seem to be in place that are consistent with recovery in economic activity. One positive factor is the improvement in financial market conditions in the past six months, which is stimulating activity in major credit-sensitive sectors of the economy. A better balance is being established between inventories and final demands. Inflationary expectations, while still sensitive, have abated. There has been substantial progress towards restoring price stability, and there is good reason to believe that further progress can be achieved even as business activity picks up. An improvement in productivity should bolster growth in real income and profitability during recovery, and can be a factor in sustaining better price performance. Diminishing inflation and a lowering of inflation expectations, in turn, should promote further declines in interest rates.

Against this backdrop, monetary policy has been, and will continue to be, concerned with fostering a lasting expansion in business economic activity in a framework of continuing progress against inflation. Monetary expansion and liquidity should be adequate to support the moderate recovery that appears to be starting. At the same time, although the recent gains that have been made against inflation are highly encouraging, it is clear that the test of the success of our anti-inflationary effort is still ahead. Thus, the Federal Reserve remains committed to a course of monetary discipline that is essential to avoid a resurgence of inflationary pressures as economic expansion proceeds.

In setting guidelines for monetary growth consistent with these goals, the Federal Open Market Committee recognized that the relationship between growth ranges and ultimate economic objectives had deviated substantially from past patterns during 1982. As noted earlier, monetary growth was quite rapid relative to income and by year-end exceeded the targets set by the Committee for 1982. This growth, however, appeared fully consistent with the needs of the economy and progress against inflation, given the indications of unusual demands for monetary assets that persisted during the past year. With velocity declining sharply, rigid adherence to the 1982 targets would have produced a much more restrictive economic effect than was appropriate.

The atypical behavior of velocity last year will likely prove at least in part temporary, to be followed by an unwinding of the exceptional liquidity demands this year; appreciable increases in M1 velocity, in particular, are common during the early stages of economic recovery. However, it may well be that the experience of 1982 reflected in part a more basic shift in underlying demands for money, at least as currently defined. Institutional changes have led to the increased availability of transactions accounts that pay interest tied to market rates, and this is likely to affect the trend growth of money. The deceleration of prices may increase the incentives to hold money over time, especially as the reduced inflation is reflected fully in market interest rates. These considerations suggest that velocity in 1983 may well follow a pattern different from that of past recoveries. In setting targets for 1983, account had to be taken of the experience of 1982, past cyclical behavior, and the possible alteration of underlying relationships between money and ultimate economic objectives.

The members of the FOMC also recognized that the introduction of new deposit instruments very recently has affected, and would continue to affect for a time, the growth rates and behavioral characteristics of the various aggregates. The extremely rapid build-up of money market deposit accounts (MMDAs), in particular, already has resulted in a substantial flow of funds into M2 from market instruments, greatly inflating the growth of this aggregate in the current quarter. It is anticipated that the redistribution of funds associated with the MMDAs and, to a lesser extent, Super NOW accounts will continue to influence the behavior of the aggregates, though the effect of such shifts on growth rates of the different monetary measures clearly cannot be determined with a high degree of confidence.

While effects of these new deposit instruments on M1 seemed smaller than might have been expected to date, the rapidly changing composition of M1 since the introduction of nationwide NOW accounts at the beginning of 1981 seems to have altered, and made less predictable, the behavior of that aggregate. The NOW accounts appear to behave partly like savings accounts and partly like transactions accounts. Thus, the pattern of M1 movements has come to be influenced by individuals' attitudes toward saving as well as by transactions needs and interest rates. As a result, the relationship of this aggregate to income may well be in the process of change that, by the nature of things, can only be accurately determined as new behavior patterns are reflected in the data over time. Though they have not grown rapidly in the early weeks of the year when depository institutions were promoting MMDAs so aggressively, Super NOW accounts, which can be offered free of interest rate ceilings, have the potential for further disturbing M1 behavior relative to historical tendencies.

All of these factors contributed to the complexity of setting target ranges for 1983, and the Committee recognized that an unusual degree of judgment will be necessary in interpreting the growth of money and credit in coming months. Some flexibility in reassessing the ranges could be important. The Committee decided to continue setting target ranges for all three measures of money, but with some departures from past practice to deal with the special uncertainties it faces currently.

In the case of M2, it felt that performance of this aggregate would be most appropriately measured from a base period that would be less affected by the initial, highly aggressive marketing of MMDAs. Thus, the expected growth of M2 is 7 to 10 percent, measured from the average level of February and March 1983 to the average level of the fourth quarter of this year. This range is one percentage point higher than that set for M2 last year, but it makes allowance for some further shifting of funds into MMDAs from non-M2 sources over the remainder of the year, although at a greatly reduced pace from what evidently has occurred to date.

The range for M3 was set at 6-1/2 to 9-1/2 percent, measured in accordance with past convention on a fourth-quarter to fourth-quarter basis. This range is identical to that set for 1982, but contemplates growth below the actual outcome last year. In adopting the range, the Committee assumed that any net shifts of funds over the year into the new types of deposit accounts from market instruments would be moderate. It was thought that M3 would be less affected by the new accounts because many depositories have the option of reducing their issuance of large CDs if sizable inflows of MMDAs and other core deposits satisfy their needs for funds. Whether this in fact turns out to be the case will depend in part on the public's perceptions of the risks entailed in uninsured

investments and on the ability and desire of depository institutions to use their new liability powers to expand their market shares in financial intermediation.

For M1, a growth range of 4 to 8 percent was specified for the period from the fourth quarter of 1982 to the fourth quarter of 1983. This range, while pointing to slower actual growth than in 1982, is both wider and higher than the range tentatively set last July. The new range reflects allowance for a possible change in cyclical behavior as well as for the evolving character of M1 as a more important repository for savings, especially in a lower inflation, lower interest rate environment. The comparatively wide range set for M1 also reflects the Committee's judgment that some allowance should be made in this fashion for the uncertainties introduced by the existence of the new deposit accounts.

An associated range for total domestic nonfinancial debt was estimated at 8-1/2 to 11-1/2 percent over the four quarters of 1983. This range encompasses growth about in line with expected growth of nominal GNP, in accordance with long-term trends; however, Committee analysis of the outlook suggested that, in the particular circumstances of 1983, somewhat more rapid growth of credit also might be consistent with its overall objectives. Owing to the extraordinary size of the federal budget deficit, the share of credit flowing to the private sector is expected to be lower than experienced generally in the past. It is expected that the commercial bank share of total debt expansion will put bank credit growth at between 6 and 9 percent this year.

The Committee members agreed that the monetary ranges should be reviewed in the spring in light of the accumulated evidence available at that

time regarding the behavior of the aggregates and their relationship to other economic variables. For the time being, in implementing monetary policy, the Committee agreed that substantial weight would be placed on behavior of the broader aggregates--M2 and M3--in anticipation that current distortions from the initial adjustment to the new deposit accounts will abate. The behavior of M1 will be monitored, with the degree of emphasis given to that aggregate over time dependent on evidence that velocity behavior is resuming a more predictable pattern. Debt expansion, while not targeted directly, will be evaluated in assessing behavior of the money aggregates and the impact of monetary policy.

The Committee emphasized that policy implementation in 1983 necessarily will involve a continuing appraisal of the relationships between each of the measures of money and credit and economic activity and prices, particularly in the aftermath of unusual behavior of velocities of both money and credit aggregates last year. This will involve taking account of patterns of saving behavior and cash management among businesses and households, and indications of changing conditions in domestic and international credit markets and in foreign exchange markets.

Section 4. The Outlook for the Economy

There are encouraging signs that the economy will soon be in the early stages of an economic upturn, if indeed the expansion has not already begun. In its initial phases, the economic recovery may be less robust than the average postwar expansion, but, at the same time, the chances that the recovery can be sustained over the long run have been considerably enhanced by the significant progress against inflation in the past year or so.

Indications that the economy is turning up have been apparent in recent weeks. The housing sector appears to be well along in the recovery process, as both house sales and new construction have registered significant advances. Retail sales also picked up toward the end of 1982 and held steady in January; auto sales in particular have been at improved levels in recent months. In the business sector, inventory liquidation apparently has become less of a depressant of real activity, as both industrial production and employment showed appreciable gains in January.

To be sure, because of the length of the recession and the stresses and uncertainties it has generated, consumers and businesses may follow cautious economic strategies in coming quarters. In the business sector a high degree of unused industrial capacity probably will discourage investment spending for some time, as firms boost the operating rates for existing plant and equipment, rather than investing in new physical capital; commercial construction in the office building area may be particularly weak for a while. The export sector may well continue to be a drag on U.S. economic activity well into 1983. Exports

fell sharply in the second half of last year, and given the widespread weakness in foreign economies and the still high value of the dollar, there is not likely to be a quick turnaround in export demand.

Although the January employment report provided encouraging signs of improved labor demand, the gains in coming months, on balance, may be relatively moderate given the uncertainties still present in the business environment. As demands pick up initially, businesses appear likely to boost output in part by lengthening work schedules or improving efficiency, rather than by committing themselves fully to higher levels of employment. Therefore, during the early stages of the recovery, the unemployment rate probably will be slow to retrace the increases sustained during the past recession. The difficulties of bringing unemployment down quickly may be compounded by structural changes now apparent in the U.S. economy; although the service sector and industries in the forefront of technology will be adding employees, job opportunities in some traditional industries may be trending lower over a long period, and there is legitimate concern about the ability of displaced workers readily to find new employment in the expanding sectors.

Nevertheless, once the recovery is under way, there appears a good chance that it can be sustained. Fiscal policy is providing significant near-term support for the economy through a continued rise in defense spending, counter-cyclical transfer payments and further tax cuts. The current monetary policy, too, is consistent with an expansion: barring some unexpected reemergence of serious inflationary pressures in 1983, the monetary growth targets established by the FOMC should provide the liquidity needed to support a recovery in real activity.

A resurgence of inflation seems unlikely in the near term, even though some commodity prices may rebound from cyclically depressed levels as the recovery takes hold. The underlying trend in labor costs appears to have moved down. In addition, the current supply situations in agricultural and energy markets appear conducive to continuing progress against inflation; indeed, recent developments in the international oil market seem to portend quite favorable price movements for this key commodity.

There still are, however, reasons for concern about the longer-run outlook for the economy. One major source of concern is the prospect that federal deficits will continue to be massive in the years ahead, even as the economy is well along in the expansion. This suggests a serious risk that pressures on credit markets will mount as the credit demands of private borrowers grow with the recovery. In addition, the prospective deficits tend to cast doubt on the commitment of economic policy to gain control of inflation over the long run. For these reasons, the budgetary picture continues to have an unsettling influence on financial markets, and lenders remain hesitant to commit funds for a long period, except at interest rates that are high relative to the current pace of inflation.

Overcoming the still deep skepticism about the anti-inflation effort is crucial in other ways to the achievement of strong and sustained economic growth. It is generally recognized that periods of slowing inflation in the past two decades have proved to be temporary, and unless the commitment to see the present effort through is made fully

credible by the actions of the fiscal and monetary authorities, there will be a danger that as markets improve with recovery we will see a reversion to aggressive patterns of wage and price behavior. If this came to pass, the viability of economic expansion would be severely jeopardized.

We need, too, to deal with the strains existing in the international financial arena. Timely action to enhance the resources of the International Monetary Fund is essential. But more generally, we must maintain the spirit of cooperation among borrowers, lenders, and governmental authorities that has been the hallmark to date of the effort to resolve the difficult problems confronting us.

FOMC economic forecasts. The members of the Federal Open Market Committee, together with other Federal Reserve Bank Presidents who alternate as Committee members, believe that the economic expansion that now appears to be starting will result in a solid gain in real GNP over the four quarters of 1983. The increases expected are moderate in comparison with the first year of most past recoveries, and the consensus is that these gains can be achieved without a resurgence in inflationary pressures, especially in light of the favorable underlying trend of unit labor costs.

In formulating these projections for 1983, members of the FOMC and the Presidents took account of the target ranges established for the various monetary and credit aggregates, and assumed that Congress and the administration will make progress in the months ahead in reducing federal deficits for coming years, thereby diminishing the threat those deficits would otherwise pose to long-run price stability and sustainable economic

growth. No specific allowance was made for a large decline in oil prices; also, the special restraining influence on prices exerted by the appreciation of the dollar in 1982 is not expected to be repeated in 1983.

The ranges of growth in money and credit specified by the Committee for 1983 would appear compatible with some further decline in market rates of interest as inflation abates. However, the direction of fiscal policy decisions will play a major role. Decisive action to reduce the Treasury's demands on the credit markets in the years ahead would be well received by investors and would contribute greatly to a relaxation of the continuing pressures on interest rates. Of critical importance to the interest rate outlook--and one certainly not divorced from the budget picture--is the behavior of inflation and expectations of inflation. Lower rates of inflation contribute directly to the reduction of demands for money and credit, and sustained progress in slowing the advance of wages and prices would do much to relieve the concerns of investors as to the future course of interest rates.

Projections of the majority of the Committee members (and other Presidents) for growth in the real GNP from the fourth quarter of 1982 to the fourth quarter of 1983 were in a range of 3-1/2 to just over 4 percent, a little higher than the recent forecast of the administration, and similar to the projection of the Congressional Budget Office. Several expected significantly more growth. Nearly all believed prospects were excellent for less inflation than the 5.6 percent increase in the GNP deflator projected by the administration, with the majority expecting an increase of 4.5 percent

or less. The combination of real growth and inflation resulted in a central tendency of 8 to 9 percent in nominal GNP growth. Unemployment was expected to remain high during the first year of recovery.

Economic Projections for 1983

	FOMC members and other FRB Presidents		Administration	CBO
	Range	Central Tendency		
Changes, fourth quarter to quarter, percent:				
Nominal GNP	7-1/4 to 11-1/4	8.0 to 9.0	8.8	8.9
Real GNP	3 to 5-1/2	3.5 to 4.5	3.1	4.0
GNP deflator	3-1/2 to 5-1/2	4.0 to 5.0	5.6	4.7
Average level in the fourth quarter, percent:				
Unemployment rate*	9-1/2 to 10-1/2	9.9 to 10.4	10.4	n.a.

n.a. = not available

*Percent of total labor force including persons in the Armed Forces stationed in the United States.

APPENDIX

Note on Credit Aggregate

The specific measure of aggregate credit used by the FOMC in establishing a range of growth is the total debt of domestic nonfinancial sectors, as derived from the Board's flow of funds accounts. This measure includes borrowing by private domestic nonfinancial sectors and by the federal and state and local governments, in U.S. markets and from abroad; it excludes borrowing by foreign entities in the United States.

Various statistical tests were used to compare this measure with other potential credit aggregates--such as totals that included borrowing by foreign entities or by financial institutions, or that were augmented by equities. Comparisons also were made with less comprehensive totals such as aggregate private borrowing or financial assets other than equities held by nonfinancial sectors. In these comparisons, which involved examining the stability and predictability of relationships to GNP and other economic variables, the domestic nonfinancial debt total generally performed as well as or better than the other series considered. The private borrowing aggregate clearly performed least well.

Behavior of Domestic Nonfinancial Sector Debt
(changes in percent, fourth quarter to fourth quarter)

Year	Change in Debt	Change in Ratio of Debt to GNP
1960	5.2	3.1
1961	5.7	-1.6
1962	6.7	0.9
1963	6.9	0.3
1964	7.2	1.2
1965	7.2	-3.0
1966	6.9	-1.1
1967	6.8	0.5
1968	8.4	-0.9
1969	7.1	0.3
1970	6.9	1.9
1971	9.3	-0.3
1972	10.0	-1.4
1973	11.3	-0.2
1974	9.3	2.1
1975	8.9	-1.0
1976	10.7	1.3
1977	12.3	0.1
1978	12.9	-1.6
1979	12.3	2.4
1980	9.9	0.4
1981	10.1	0.4
1982	9.1	5.7
Memorandum:		
Average annual change	8.7%	0.4%

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1983

FRIDAY, FEBRUARY 18, 1983

U.S. SENATE.
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

The CHAIRMAN. The Banking Committee will come to order.

I do note the hour of 9:30 when the committee was scheduled to meet and the attendance of Senator Proxmire, Senator Gorton, Senator Trible, and the Chairman. This is a continuation on the hearings on current monetary policy and conditions.

Two days ago we had Chairman Volcker, Chairman of the Federal Reserve Board. This morning we are to hear Hon. Martin S. Feldstein, Chairman of the Council of Economic Advisers; and after he has completed, we'll hear from Andrew Brimmer, president, Brimmer & Co.; John Paulus, chief economist and vice president, Morgan Stanley & Co., New York City; and Mr. Richard Zecker, senior vice president and chief economist, Chase Manhattan Bank, New York City.

I do not note the presence of our first witness. I do note that our Senate Banking Committee has started on time, as all Senate committees should, and now we will entertain any statement my colleagues wish to make awaiting the presence of Mr. Feldstein.

Senator PROXMIRE. Mr. Chairman, I have no opening statement except to commend you on being so prompt in holding these hearings. I think, if not unprecedented, it's very rare. Once in a while a chairman will be on time, but you're always on time and I think that's a marvelous element that we can count on in this uncertain world, and I see our witness is here so I will desist my filibustering and join you in welcoming our distinguished Chairman of the Economic Advisers.

The CHAIRMAN. As soon as your bottom touches your chair, we will be happy to hear your testimony.

Mr. FELDSTEIN. I can do that and start my mouth moving at the same time.

18-014 O—83——8

STATEMENT OF MARTIN S. FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Thank you very much, Mr. Chairman. I am please to be testifying again before this distinguished committee.

This is an especially critical and confusing time for monetary policy. It is a critical time because it is so important that the increase in money and credit during the coming year be consistent with a sound recovery. Too little money growth could choke off the recovery while too much money growth could fuel a destabilizing increase in inflation.

It is a confusing time because many of the old verities of monetary economics no longer appear to be valid. For more than two decades, the ratio of the money stock to nominal GNP moved only within narrow bands. Last year, however, this velocity ratio declined sharply, leaving nominal GNP about 6 percent lower than might have been anticipated on the basis of the money stock. And now, as a result of the significant financial deregulation enacted by Congress last fall, the broad measure of the money stock [M_2] is increasing at an unprecedented rate.

Monetary policy at the present time cannot be guided by applying mechanical rules. The Federal Reserve must use its judgment to adjust the money stock during the present temporary period of transition while asset demands are adjusting to the new regulatory arrangements. But it must also be clear that, when the transition is finished, the Fed will return to the sound and disciplined rules for controlling the growth of the money stock in a way that permits nominal GNP growth at a rate that is consistent with sustainable growth of real GNP and a moderating rate of inflation.

I believe that the Federal Reserve is trying at the present time to keep monetary policy on the middle ground that can sustain recovery without rekindling rising rates of inflation. I know that the President is confident that Chairman Volcker and the Federal Reserve Board are trying to pursue an appropriate policy and will continue to do so in the months ahead.

I believe that the procedure for 1983 that Chairman Volcker announced earlier this week is commendable. It recognizes the fundamental uncertainty about the shifts in money stocks during the first quarter of the year but then returns to the discipline implied by the target rates of money growth.

This morning I want to look first at the broader issue of the principles that should guide monetary policy at a time when a purely mechanistic application of money growth rules is inappropriate. I will then discuss the rapid growth of M_1 in the second half of 1982 and on the even more rapid growth of M_2 in the past month. Finally, I will comment on the level of interest rates at the present time and the prospect for lower interest rates in the future.

STABLE MONETARY POLICY

The administration has repeatedly indicated that the fundamental guiding principle for monetary policy in the 1980's should be a gradual reduction in the rate of growth of the money stock until the rate is consistent with price stability. This broadly monetarist

approach has also been enunicated in recent years by the independent Federal Reserve.

The basic challenge for monetary policy at present is to balance this principle of stable money growth with the need to take account of changing asset preferences that may alter the velocity of money. While maintaining the approach of setting target ranges for money growth, the Federal Reserve will also need to use its judgment to permit money growth rates to reflect changes in financial regulations and other lasting changes in asset demands.

When regulatory changes appear to be responsible for abnormal growth of the demand for money, the Fed must examine the evidence on the changing composition of liquid assets and try to determine how much more or less money growth than usual may be appropriate. Although the difficulty of such calculations cannot be overstated, there is no substitute in the medium term for such evaluations.

Regulatory changes are not the only source of changes in velocity. Individuals and institutions may change their asset preferences for other reasons as well. Any persistent change in velocity that is not matched by a corresponding change in the money stock will cause either a period of increased inflation or a period of weak economic performance. It is clear, however, that changes in the growth of the monetary aggregates must not be made easily or lightly since excess money growth will be inflationary while inadequate money growth will threaten economic expansion.

Although the monetary authorities must rely on their professional judgment in the short run, the observed behavior of nominal GNP can be used over a longer period of time to guide a gradual recalibration of the money growth targets. Basing the recalibration of monetary targets on nominal GNP is consistent with the basic principle of pursuing a stable monetary policy. Indeed, it is the relatively stable long-run relationship between the monetary aggregates and nominal GNP that justifies the Federal Reserve's policy of setting targets for the growth of M_1 and M_2. Thus the principle of targeting money growth rates is not an end in itself but only a means of achieving control of nominal GNP.

MONEY GROWTH RATES

The difficulties of pursuing a sound monetary policy are amply illustrated by recent experience. By conventional standards, the rates of growth of M_1 since the middle of 1982 and of M_2 in January are far too high and would seem likely to precipitate an inflationary surge of demand. More careful analysis, however, shows that the money growth rates cannot be taken at face value. They reflect changes in asset composition and therefore need not be inflationary.

Stated somewhat differently, monetary expansion causes inflation when the increase in the supply of money exceeds the increase in the demand for money. Since money demand generally grows at a rate that is equal to or less than the growth of nominal GNP, a rapid growth of the money stock typically means that the supply of money will exceed the demand for money and that an increase in inflation is likely to follow. However, when there is an important

regulatory change or other reason for a substantial increase in money demand, a corresponding shift in money supply will not be inflationary.

Consider first the rapid growth of the M_1 measure of the money stock since last July. From the 4 weeks ending July 21, 1982, to the 4 weeks ending January 19, 1983, M_1 grew at an annual rate of 14.2 percent. The Federal Reserve has explained that the termination of all-savers certificates was responsible for some of the abnormal increase, since the funds from the all-savers certificates were temporarily held in M_1 accounts. Even more important, I believe, was the reaction of M_1 demand to the sharp decline in interest rates.

The currency and bank deposits that constitute M_1 earn either no interest or interest at fixed rates. When the return available on other assets like money market mutual funds is high, individuals and businesses will economize on their M_1 balances. When those alternative rates are low, individuals and businesses will have less incentive to economize on M_1 balances and the size of those balances will grow. There have been many statistical studies that confirm this relationship between the interest rate and the demand for M_1.

Between June and December 1982, the interest rate on commercial paper fell from nearly 14 percent to less than 9 percent. This fall in interest rates was in line with the fall in inflation during the previous months. If this 5-percent fall in the interest rate caused the amount of M_1 demanded to rise by 5 percent over 6 months, it would cause the annualized rate of growth of M_1 to increase by 10 percent. Thus a one-time level shift of 5 percent in M_1 demand that is phased in over 6 months would make a 4-percent rate of growth of M_1 appear as a 14-percent rate of growth.

I have used round numbers to illustrate my point and do not want my statement interpreted to mean that I believe that the shift-adjusted increase in M_1 during the past 6 months was at a rate of 4 percent. But I do want to emphasize that the substantial increase in M_1 should be seen primarily as a level shift and not as excessive monetary growth. If inflation stays at its current level and short-term interest rates do not rise appreciably, there is no reason for a subsequent reversal of this temporary period of high M_1 growth.

Although M_1 rose rapidly in the second half of 1982, the growth of M_2 during that period continued essentially unchanged at slightly above 9 percent. This was further evidence that the rise in M_1 was at the expense of the interest-bearing components of M_2 and thus represented only a predictable change of portfolio composition.

The major changes in banking regulation that went into effect in December and January—the money market deposit accounts and the super NOW accounts—have introduced a new and substantial source of temporary instablility in the relationship between the monetary aggregates and nominal GNP. The money market deposit accounts have given banks an opportunity to attract deposits of funds that would otherwise be held outside the banks and outside M_2. The result is an increase in the measured value of M_2 that reflects a shift of funds rather than an unwarranted increase in M_2

growth. Although the M_2 stock rose at a 30-percent annual rate in January, it is far better to see this as a 2.5-percent increase in the stock of M_2. Fortunately, the financial markets recognized the nature of the M_2 increase and did not reflect any fear of increased inflation. Instead, long-term interest rates remained essentially steady.

Although the surge in M_2 is readily understood as the result of deregulation, it does make it difficult to assess what is really happening to the growth of liquidity, that is, to the growth of M_2 adjusted for the shifts induced by deregulation. The behavior of M_2 is not a useful guide since the regulatory changes are affecting M_1 as well: Some of the flow of business deposits into MMDA's is coming from M_1 while funds are also being attracted into M_1 by the super NOW accounts. As a result, the Federal Reserve must monitor closely during the months ahead the sources from which the growth of M_2 may have originated. Ultimately, the Fed must also monitor the behavior of nominal GNP itself. It is critically important during the early phase of the recovery to prevent an excess of liquidity from rekindling the inflationary spiral.

INTEREST RATES

I have been talking for the past few minutes about the monetary aggregates and mentioning interest rates only in passing. I recognize, of course, that interest rates are now of great concern to many businesses and households. There is a justifiable concern that interest rates—especially real interest rates—are now very high and that such high rates threaten the economic recovery. At a minimum, these high rates will produce a lopsided recovery in which the interest-sensitive sectors of the economy do not share in the general expansion. Housing, construction, and the capital goods industries will remain weak. Moreover, the high real interest rates will keep the dollar strong and this will depress our export industries and those industries that compete with imports from abroad.

The primary cause of the high real interest rates is the very large budget deficits that still hang as a cloud over the economy for the entire decade of the 1980's. Without legislative changes, the deficit will remain at more than 6 percent of GNP for the indefinite future. Such deficits raise long-term interest rates in two ways. First, financial investors anticipate that the Government in future years will be competing with potential private borrowers for the available pool of savings. Reducing the demand of the private borrowers to the available residue of funds requires raising the real rate of interest that such prospective borrowers will face.

Second, in addition to raising the real interest rate, the prospect of large future deficits also increases the fear of inflation and therefore the nominal interest rate. There seems little doubt that the current high interest rates reflect the fear that inflation will rise significantly in the future.

It is tempting to think that the Federal Reserve could reduce the interest rates by an expansionary monetary policy. In reality, however, an expansionary monetary policy would only increase the financial market's fear of inflation and drive interest rates higher.

Now the emphasis of economic policy must be on reducing the budget deficits in the years ahead. Let me add, however, that I also believe that the idea of reducing the budget deficit by eliminating (or "postponing") the indexing of tax brackets would be counterproductive. Everyone would soon recognize that deindexing the tax law would produce relatively little additional revenue if the inflation rate was low but a great deal of extra revenue if inflation is high. Deindexing the tax law would produce a powerful incentive for Congress to force the Fed to follow an inflationary monetary policy. I believe that the immediate effect of deindexing the tax law would be a rise in long-term interest rates and a weakening of the recovery.

The fundamental conclusion from these considerations is clear: The only way to reduce long-term interest rates is to make legislative changes now that will assure that the outyear deficits will be an acceptable fraction of GNP. Doing so will reduce both nominal and real interest rates.

MONETARY POLICY

My comments have drifted away from monetary policy in order to focus on the fundamental cause of the current high interest rates. The critical task for monetary policy now is to permit the monetary aggregates to expand at a pace that is consistent with sound growth and moderating inflation. The difficulty is achieving this at a time when major regulatory changes have temporarily altered the normal relationship between the monetary aggregates and nominal GNP.

The combination of monetary rules and discretion must be applied with great care and judgment. The observance of rules must not become a doctrinaire attachment to arbitrary standards, and the exercise of discretion must not degenerate into unprincipled fine tuning. Instead, the monetary rules must be understood as a way of achieving an appropriate long-run path for the economy. The exercise of discretion in recalibrating monetary targets must be subject to the discipline that such revisions are ultimately compatible with the desired long-run path of nominal GNP. With rules and discretion balanced in this way, monetary policy can support a sound recovery that leads to sustained and noninflationary growth.

The CHAIRMAN. Thank you very much, Mr. Chairman.

Your statement appears to blame the persistent high interest rates almost entirely on the prospect of continuing large Federal deficits. In our hearings with Chairman Volcker and in other hearings we have held recently, I have stated over and over again how I agree with that philosophy as far as long-term interest rates are concerned.

People would be foolish to make reasonable long-term loans with prospects of continuing $200 billion deficits.

CONTINUED HIGH SHORT-TERM INTEREST RATES

The question I asked him and would ask you now is I don't understand why we continue to have such high real short-term rates. All of the testimony that I have taken before this committee, the testimony we will hear today in addition to yours, is to the effect

that no one expects inflation to reignite in the short period, over the next year or two.

Excess plant capacity and all sorts of other indicators seem to say that now we've got it under control at least for a while.

I understand the fragile nature of the outyears and again the long term, but I still have a very strong feeling that the short-term rates are entirely too high from all of the evidence we have before us and I can't seem to get an answer as to why the short-term rates still stay up. There seems to be no risk with much more reasonable short-term rates with all the information that's come before this committee.

Mr. FELDSTEIN. I think you're absolutely right in making the distinction between the long rate and the short rate in this context, saying the long rate is easily understood in terms of inflation fears coming from the budget deficit, while the short term is more of a puzzle.

I thought about that question a lot in the early part of the summer. Let me try to explain why I think those rates are high and also I will submit for the record a short piece that I wrote for the Wall Street Journal back in June, titled something like "Why are the Interest Rates So High," but really addressed to the question of why the short-term rates were so high.

[Copy of article referred to follows:]

[From the Wall Street Journal, June 8, 1982]

WHY SHORT-TERM INTEREST RATES ARE HIGH

(By Martin Feldstein)

Though the rate of inflation has fallen sharply since last year, interest rates have shown no inclination to decline by anything like an equal amount. While the rate of inflation as measured by the GNP price deflator declined from more than 97 percent last year to less than 4 percent in the first quarter of this year, short-term interest rates have declined less than 2 percent and long rates are essentially unchanged.

The result has been a rise in the real interest rate (the excess of the market or nominal interest rate over the inflation rate) to a level that is without precedent in the postwar period.

The high level of real short-term and long-term interest rates depresses investment, prolongs the recession and enlarges the government deficit.

Any change in Fed policy aimed at lowering interest rates would be a mistake. The high rates are an inevitable consequence of the disinflation process. With time, the nominal market interest rates and the corresponding real rates will return to their normal range. Any attempt to hasten the process by expansionary monetary policy would risk a reacceleration of inflation.

A CHANGE IN INFLATION RATE

Though the level of real interest rates is abnormally high, there is nothing unusual about a change in the rate of inflation causing a change in the real rate of interest. A change in the inflation rate ultimately induces a similar change in the nominal interest rate, but experience shows that the interest rate change occurs only gradually. In the 1960's and 1970's the interest rate rose too slowly and the real interest rate fell. A similar delay in responding to the recent distinction has now produced a high real rate of interest. The real level is unprecedented only because the recent decline in the inflation rate has been so large.

It is easy enough to understand why long-term rates have not declined sharply. The long rate depends not on the current rate of inflation but on the expected rate of future inflation. Prospective bond buyers remember that the GNP price deflator was rising at nearly 10 percent as recently as the final quarter of last year. They are aware, moreover, that the Fed's relatively tough policy during the past 18 months is no guarantee that it will want to give primacy to fighting inflation during

the rest of the decade. And while these concerns have limited the potential decline in long rates, the revised budget outlook that turned last year's projected budget balance by 1985 into a forecast deficit of nearly 5 percent of GNP has given a countervailing upward thrust to interest rates. The net result has been a continuation of high nominal rates.

The long-term rate will move down only as continuing experience confirms that there will be a lasting decline in inflation and that large deficits will not require a sharp rise in the real interest rate to curtail private investment. This decline in long rates will be hastened when a drop in the short-term interest rate raises the cost of not buying bonds.

The high level of short rates is thus important not only in itself but because it contributes to the high level of long rates. To judge by what I've heard and read, the basic reason for the persistence of the high short rate is not well understood. Explanations in terms of future budget deficits or inflation rates are relevant to the long rates but not to the short. The argument that the increased volatility of short rates induces an extra risk premium makes no sense, both because there is no investment with less volatility risk and because the increased volatility of long rates should be driving investors into short-term securities and thereby lowering their yields. Similarly, the argument that risks of bankruptcy and default have increased interest rates cannot explain why the default-free Treasury bills should have high yields; indeed, the flight by investors from risky private obligations to the haven of government securities should lower the Treasury bill rate.

There is one basic reason for the high short-term interest rate: The supply of money is low relative to its demand. The short-term *nominal* interest rate is the price that equates the supply and demand for non-interest-bearing money. While the *real* interest rate regulates the supply and demand for credit through changes in saving and investment, it is the nominal short rate that represents the cost of holding M1 money balances that don't bear interest instead of holding T-bills, commercial paper, or interest-bearing time deposits in banks or money market funds.

Individuals and businesses therefore choose to hold less M1 relative to the level of transactions when the nominal short-term interest rate is high than when it is low. This implies that when the quantity of money that the Fed supplies is low relative to the level of transactions, the interest rate must be high to bring money demand into equality with the money supply.

The volume of M1 has been virtually unchanged since the beginning of this year and grew at less than 3 percent last year. Because money has been relatively scarce, the interest rate has remained high.

Many economists did not anticipate the sharp rise in the short-term real interest rate but expected that the nominal interest rate would decline as the inflation rate dropped. Their view was based on the simple frictionless economy of the textbook world. In such an economy, a reduced rate of money growth not only lowers inflation but also causes a decline in the nominal interest rate that keeps the real interest rate essentially unchanged. Though the lower nominal interest rate increases the demand for money, this is offset in the textbook world by an immediate drop in the price level that reduces the demand for money to the available supply. Immediate and complete downward flexibility of prices in the textbook world permits disinflation to occur without higher real rates of interest.

In the real world, of course, the price level does not conveniently decline instantaneously by several percent to reduce money demand and permit a decline in the nominal interest rate. Instead, the real interest rate rises and this high real rate induces a decline in economic activity. The lower level of economic activity and the decline in inflation that it causes both reduce money demand but not by enough to permit an immediate return of the real interest rate to its natural level.

As long as the real interest rate is above its natural rate, there will be slack in the economy and therefore downward pressure on inflation and interest rates. The real interest rate is thus eventually self-correcting.

No one can say exactly how long it will take for the real short rate to return to its natural level. Some simple arithmetic will indicate the nature of the adjustment process. There has been a relatively stable trend that reduces money demand by about 3 percent a year apart from changes in interest rates and the level of income. A 5 percent rise in nominal GNP this year would raise money demand at current interest rates by only 2 percent. If the Fed permits M1 to increase by 5 percent, there will be a net increase in M1 liquidity of 3 percent. The result would be a decline in the nominal interest rate. Similarly, if 1983 M1 growth is 4.5 percent, a further decline in the nominal interest rate will occur if nominal GNP grows by less than about 7.5 percent.

This arithmetic makes it clear that it is the stickiness of the price level that keeps the short rates so high and that causes a prolonged recession to accompany the process of lowering the inflation rate. The faster inflation declines, even if that decline is only a temporary downward overshooting of the equilibrium inflation rate, the faster will the subsequent real interest rate decline and the sooner will the level of economic activity recover.

It is tempting to think that this painful process of reducing money demand by extra price deflation could be avoided if the Fed simply accommodated the additional money demand by providing an extra dollop of money supply. Unfortunately, the Fed's credibility is so fragile that the financial markets and other Fed watchers would almost certainly interpret the accommodation as evidence that the Fed has abandoned its policy of gradually reducing the money supply. Long-term inflation expectations would worsen, and the interest rate on bonds and mortgages would probably rise even if the short rate was lowered. Moreover, such monetary accommodation would be a return to the notion of interest rate targeting that produced inflationary money growth for the past 15 years. There is no reason to think that monetary fine tuning would be more successful this time.

There seems little choice but to wait until the natural process of disinflation reduces the relative demand for money, thereby lowering the nominal interest rate and bringing the real rate back to its natural level. The painful recession that accompanies this disinflation is the inevitable cost of correcting the inflationary excesses of the past decade and a half.

Mr. FELDSTEIN. Basically, the short-term nominal interest rate has to clear the demand for money. The demand and supply of money has to be equated using the nominal short-term rates regardless of the implications that that has for the real rate. So one way of answering the question is to say that the amount of the real money stock, the real M1 money stock that we have at the present time, is relatively small in comparison to our level of nominal GNP and the only way to equate the demand for that M_1 stock with the available supply is to have a high short-term nominal interest rate because it is the short term nominal interest rate that is the cost to the individual of holding M_1 balances.

Now then the question is what makes that go away? What makes that change? Let me answer it first withh my old professorial hat on for a minute and then try to answer it more practicably.

In theory, the fact that inflation came down a great deal should not have led to higher real interest rates. Instead, nominal rates should have come down at the same time. The only way for that to happen is for the real money stock to increase. For the real M_1 money stock to increase there are two things that might happen. One is that the Fed could pour some more money into the system. The other thing is the price level could drop.

In the theoretical world that I lived in before I came to Washington on my blackboard, that process——

The CHAIRMAN. What makes you think you're in the real world here?

Mr. FELDSTEIN. In that analytically simplified world, the way in which real money balances adjust is for the price level to drop. In other words, when the inflation rate comes down, the price level in these little abstract models that economists like to think about, drops substantially and immediately. If the price level were to drop substantially, then we would, with the same nominal money stock, have more real money balances and more real M_1. With more real M_1, we would have a lower nominal interest rate now.

Now that hasn't happened or at least it hasn't happened fast enough to give us the larger M_1 balance. So there are two possibilities. We can have the Fed inject additional funds, try to increase M_1 in order to bring down that short rate, or we can wait until over time this process happens naturally. That is, that nominal GNP grows more slowly than the money stock that the Fed is providing and that allows for interest rates to decline.

The risk in taking the first route, the risk in the Fed adding more money now, is that it will increase the fear of long-term inflation. It runs the risk of increasing long-term interest rates, and I felt 6 months ago and 8 months ago when I first started thinking about this that the Fed was not in a position then to increase the stock of money without forcing up long-term rates. It would drive down short-term rates but would drive up long-term rates in the process.

In fact, my speculation at that time was wrong and the Fed was able to accommodate a natural decline in short-term rates without long-term rates going up, and even long-term rates coming down.

My sense, talking to financial market people in September and talking to them again now, is that the thinking in the financial community has changed a lot and that people who were not nervous about an additional supply of money of M_1 6 months ago are very nervous about it at this time.

So I don't think the Fed is in a position where it can inject those additional funds to try to bring down short-term rates without running very substantial risks that it will push up long-term rates further. I don't know whether I clarified or complicated matters with that.

The CHAIRMAN. Well, let's get very practical then and let me ask you—in the hearing with Chairman Volcker I used the term profiteering and that may have been too strong a word, but let me rephrase the questions.

Do you believe that there's a possibility that financial institutions are deliberately holding rates up?

Mr. FELDSTEIN. Not market rates certainly. Treasury bill and commercial paper rates are set on a very competitive, worldwide market, so that those are not in any sense administered rates.

When we start asking about things like the prime rate or specific rates for a particular class of consumer loans or mortgages, banks may have some more discretion over that, but frankly, I don't think they have a great deal of discretion because, again, we have a very competitive market. They may administer what they call the prime rate, but then they will vary who gets to borrow at prime and who gets to borrow above and below prime, so that ultimately I think the effective interest rates that people are paying are determined by market conditions.

LENIENCY IN BANKRUPTCY LAWS

The CHAIRMAN. Do you think part of it might be due to the fact that they are taking precautions against rising loan losses? Do you think that the changes—the great leniency in the bankrupcy laws have had anything to do with these increasing rates, protecting themselves against those losses?

Mr. FELDSTEIN. Well, the changes in the risks associated with any given loan clearly can affect the interest rates that they charge. As the argument that they have taken losses on some of their previous loans and would now like to make more profits to help offset those loans—it's certainly true that banks would like to make more profits to offset losses that they have accrued in the past, but liking to doesn't necessarily make it possible. I don't see the connection that says merely because they have incurred losses they are now in a position to charge higher interest rates. It may be that they are being more careful about the kinds of loans that they make, that they would rather not make certain loans. In fact they have reduced the supply and therefore the interest rate that appears in the market is high.

The CHAIRMAN. Well, it's a different subject for another time, but I do feel very strongly that we've got to change the errors we made in the bankruptcy laws. It has become so incredibly easy. I was brought up by a father that taught me if you borrowed money you were supposed to pay it back. It was just that simple. I do think the bankruptcy laws need to be changed dramatically in the other direction, that we made a great error when we liberalized them so much.

Let me ask you what your view is of the seriousness of the threat to our economic recovery coming from the debt service problems of the less developed countries. At the same time these hearings are going on, Senator Heinz, the chairman of the International Finance Subcommittee, has been conducting hearings on that issue. I'm specifically referring to those debt service problems, the request from the administration for an increase in the IMF quotas and what your feelings are on that situation.

Mr. FELDSTEIN. Well, I think that the problems of the less developed country borrowers—Brazil, Mexico, Argentina, and many others—are indeed very serious. To speak first about the IMF question and then about the impact on recovery, I think the IMF is clearly playing a critical role in working out this debt repayment problem. Without the IMF, I shudder to think about what the prospects are of successfully working out the complicated coordination problem of getting this repayment done.

The IMF, of course, is not carrying the bulk of the financing of it. That has to be borne and is being borne by the private banks, but the IMF is playing a pivotal role and I very much support the request for additional funds by this Government to join with all the other governments in aiding the IMF in doing that job.

Even with the IMF, even given the role that the IMF can play in allowing these countries to continue their current activities, they will contribute to a reduced level of world trade and that will put a further damper on the overall economic recovery. Experts tell me that we are likely to have a merchandise trade deficit this year of about $75 billion, about 2.5 percent of GNP, about twice last year's level. That means that much final demand is being directed to foreign markets rather than to the domestic economy and that's clearly going to put a damper on the level of economic recovery in this country.

Only a small part of this is due to the OECD debt problem, but it is one of the contributing factors.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Chairman Feldstein, in the last 25 years, every Chairman of the Federal Reserve Board—Martin, Burns, Miller, and Volcker—have all told us about the very serious relationship between fiscal policy and monetary policy and monetary policy is very, very hard to operate without a sound fiscal policy.

At the same time, we all know now that any recovery must have an accommodative, supportive monetary policy.

I'm wondering, years ago there was what was known as a quadriad, as you know, consisting of the Treasury Department, the Chairman of the Council of Economic Advisers, the head of OMB, and the Chairman of the Federal Reserve Board.

It seems to me they met about once a month and I thought that kind of meeting was constructive. Do you have that sort of formal, regular discussion now?

Mr. FELDSTEIN. Well, we do in two different ways. I meet with Paul Volcker on a regular basis.

Senator PROXMIRE. How often?

Mr. FELDSTEIN. Every 2 weeks regularly. We often meet in between, but there's a scheduled meeting every 2 weeks. Donald Regan, I think, sees him on the same frequency. We each see him separately on those occasions, but Paul comes to a working breakfast that includes Treasury, CEA, OMB and three others on an irregular basis. I'd say that group meets every week.

Senator PROXMIRE. Would you say that Stockman comes to that?

Mr. FELDSTEIN. Stockman, Don Regan, myself, Secretary Baldrige, Secretary Shultz, and Mr. Harper.

Senator PROXMIRE. That's a regular meeting?

Mr. FELDSTEIN. That group that I just described meets every week.

Senator PROXMIRE. I see.

Mr. FELDSTEIN. And Paul Volcker comes some of the time.

Senator PROXMIRE. That's reassuring. I didn't know that and I think that's most helpful. In fact, that's a more frequent meeting than they've had in the past.

Mr. FELDSTEIN. This is scheduled this way now.

Senator PROXMIRE. Then I wonder if you can tell us how can the Federal Reserve Board provide a monetary ease that will bring interest rates down in our recovery while permitting our credit system to fluctuate between $150 and $200 billion a year for the next 5 years at deficits that will absorb half or more of our net private savings? How can they do that?

Mr. FELDSTEIN. Well, you're not asking me about two quite different things. I think that the kind of target that Paul Volcker suggested and the FOMC approved are certainly consistent with economic growth at the rates that the adminstration and others have forecast. That is, if we see M_2 growth in the coming year at 7 to 10 percent range, that certainly is consistent with nominal GNP growth in the 8 to 10 percent range, and therefore, with the real growth and the relatively stable rate of inflation we have talked about.

As far as the financing of the debt goes, the financing of the debt is really quite separate from monetary policy. The financing of the

debt is dependent on how much savings we have and on the crowding out that occurs.

IMPACT OF ADDITIONAL MONEY SUPPLY

Senator PROXMIRE. Let me follow up and ask this. If the Fed permits the money supply during the next year or so to rise by that proportion, won't the expanded liquidity base constitute a potential time bomb that may lead to a mammoth inflation in later years and won't the anticipation of that be just what the Chairman was implying a while ago? It would be recognition on the part of long term investors that you have this dynamite of liquidity available, won't that make people feel that we're going to have a very serious inflation in 1985, 1986, and 1987?

Mr. FELDSTEIN. What you're talking about in that question is the monetary aggregates increase rather than the debt?

Senator PROXMIRE. Well, yes. I'm talking about the fact that the huge deficits must be financed and this will make it difficult for people to buy homes and buy cars and buy the other things they have to buy on credit.

Mr. FELDSTEIN. I think you're really talking about two separate things.

Senator PROXMIRE. But they are interrelated, are they not?

Mr. FELDSTEIN. Not really.

Senator PROXMIRE. Why not?

Mr. FELDSTEIN. In the one case we're talking about Government debt. We're talking about borrowing by the Government. We're not talking about additional liquidity but changing the form. That is, if I buy a Government bond rather than buying a corporate bond, that doesn't change my liquidity. It does reduce the ability of the corporate sector to invest. It does create the crowding out problems that I alluded to in my testimony.

Senator PROXMIRE. If you buy them, yes; but if the Federal Reserve Board buys them through their open market operations?

Mr. FELDSTEIN. Absolutely.

Senator PROXMIRE. In order to make it possible for the economy to fund both this colossal deficit and at the same time provide credit for the private sector——

Mr. FELDSTEIN. That is exactly the kind of thing that financial markets are worried might happen in the future. There's no necessary reason for that to happen. We can have large deficits with all of the problems that ensue from those deficits without having inflation. But if the Federal Reserve does go in and buy up those deficits or buy up more of those deficits and create more money, then we'll have more problems.

Senator PROXMIRE. If the Federal Reserve does not step in and finance those deficits, there will be crowding out, won't there?

Mr. FELDSTEIN. Absolutely. Indeed, the crowding out will happen——

Senator PROXMIRE. Ninety-four percent of the net private credit could be absorbed by the deficit and off-budget credit programs.

Mr. FELDSTEIN. That's correct, and that crowding out will happen essentially regardless of what the Federal Reserve does. It can affect that crowding out ever so little by trying to monetize. You

can create a lot of inflation, but it can't change the basic reality that the Government is borrowing those funds and they're not available for private use.

Senator PROXMIRE. Why not, if the Federal Reserve Board steps in and buys it up?

Mr. FELDSTEIN. They don't create any more additional savings.

Senator PROXMIRE. Wright Patman, the old chairman of the Joint Economic Committee, used to ask William McChesney Martin, "Why doesn't the Federal Reserve Board buy up the whole national debt?" Martin's reply was, "They could, but it wouldn't be worth anything when they got it," indicating the tremendous inflationary effect of that kind of policy. But you're telling me now there would be little or no inflationary effect if the Federal Reserve Board moves in and monetized the debt to the extent of buying half of it or three quarters of it?

Mr. FELDSTEIN. Quite the contrary. There would be a lot of inflationary effect, but it wouldn't change the crowding out of private investment. That is, if we have a certain amount of GNP, a certain amount of real resources available, and the Government spends more of it or by its tax policy induces consumers to spend more of it, then those resources are not available for the investment in plant and equipment and businesses.

The fact that the Fed comes along and prints some more money doesn't change the face of reality that we have a certain amount of GNP and the Government has spent what they've spent and the consumers have spent what they have spent.

Senator PROXMIRE. But if the Federal Reserve Board comes along and pumps enough money into the economic system, won't that at least temporarily provide the basis for holding down interest rates?

Mr. FELDSTEIN. If the Fed put in more money, allowed M_1 to grow, it might reduce short-term interest rates. An increased M_1 might reduce short-term interest rates, but at the same time it would run the risk that long-term interest rates would rise immediately and it's those long-term rates to which housing and other kinds of investment are so sensitive.

Senator PROXMIRE. I understand that. But as I've read people like Tobin and others, they seem to argue that if the Federal Reserve Board increases the available supply of money even with the enormous deficits we're running, if they maintain the present level of M_2 for a while for instance, that that will permit us to maintain not only short-term interest rates at a low level but it will help us to hold down long-term interest rates because, as you have told us and others have told us, the likelihood is we will not have inflation for the next year or two anyway.

Mr. FELDSTEIN. The long-term rates are very sensitive to expectations out in the future.

Senator PROXMIRE. Yes, but we are converting some of our usual long-term borrowing into a different kind of a situation with variable interest rates. For instance, we have variable mortgage rates becoming the rule now so that the lenders are protected in that way.

Mr. FELDSTEIN. To the extent that we are moving in that direction and all that matters is short-term rates, we are talking about a different kind of problem; but if we're concerned about what is

happening to conventional long-term mortgages and long-term bonds, I'm afraid injection of additional liquidity would run the risk of increasing those long-term rates.

Let me say a little more about the conversion problems you talked about. Many borrowers are unwilling to make long-term commitments on the basis of floating rates. Would-be homeowners want to know what their monthly payments are going to be in the future. Business that are putting up a new plant want to know what their cost of funds is going to be. So they are reluctant to make those kinds of outlays unless they can get long-term funds at what they regard as reasonable rates.

At the same time, the people in the financial markets are looking into this murky future and saying with the deficits of the sort that are out there there is a risk that we're going to have substantial inflation and we'll only buy those long-term bonds if we are given enough of a risk premium, enough of an inflation premium, to protect us against the risk of that extra inflation.

So what we have is a situation in which the financial investors will only buy the bonds if they have high rates because they are afraid of inflation. At the same time, the would-be borrowers are saying, "We can't be sure we're going to have higher incomes to pay off those mortgages with, or higher prices to justify the higher rates for our business." So the buyers and sellers are not coming together. I think that's really the serious problem. The home buyer or the business investor will be unwilling to pay the kind of high interest rates that the financial investors are demanding because there is this, an uncertain amount of inflation out there in the future.

Senator PROXMIRE. My time is up, but let me just see if I understand. You're saying that there's little or nothing that the Federal Reserve Board can do by way of an easier monetary policy to hold down interest rates which would coincide with the position that the Chairman of the Federal Reserve Board has taken?

Mr. FELDSTEIN. That's correct, relative to what they are doing.

The Chairman. Senator Trible.

Senator TRIBLE. Thank you, Mr. Chairman.

The great strength of the dollar in the last year or so has been a major factor in the decline in American production and jobs. Chairman Volcker said falling exports accounted directly for some 35 percent of decline in our GNP during this recession. I've seen how the high price of the dollar affected my own State, for example. In Virginia, the demand for coal and agricultural products has diminished and tourism is in decline, and we have increased competition from foreign textiles and other products.

All of that means loss of jobs and income. I have two questions in that regard.

FUTURE OF THE PRICE OF THE DOLLAR

Do you expect any reduction in the price of the dollar in the near future and how will the new Federal Reserve policies articulated by Chairman Volcker the other day affect the price of the dollar and American jobs?

Mr. FELDSTEIN. There are two forces that affect how the dollar moves in the coming year. One, is the trade deficit. Normally when you have a large trade deficit, you would expect that to put downward pressure on the dollar; but at the same time we have very high real interest rates from these deficits, very high long term interest rates, following from these budget deficits and they are putting upward pressure on the dollar.

So what will come out in 1983 will be a balancing of these two. I would tend to think that despite these unprecedented trade deficits, we will see the dollar not falling sharply. Forecasting exchange rates is like trying to forecast what the stock market or interest rates will do. The dominant force will be the high real interest rates and the Government deficit keeping the dollar strong. That means a continued adverse effect on our trade, both our export industries and those industries that have to compete with imports from abroad.

I think it's only as markets get confident that we are bringing down inflation and that we are bringing down the Government's need for funds in the outyears that we will see a decline in the dollar relative to other exchange rates, and therefore strengthening, with a lag, of our trade position.

You asked what the impact of the Federal Reserve policy is going to be on this. I would say relatively little. I would say the dominant factor affecting our exchange rate is going to be those high long term real rates, which reflect fiscal policy more than monetary policy.

Senator TRIBLE. There's a great deal of concern, of course, about the budget deficits projected for the outyears. The numbers are staggering by any measure. As you know, the budget process moves slowly—painfully slowly in this institution and the other body across Capitol Hill. The next fiscal year's budget will not be resolved any time soon.

Since you have your projecting hat on today, recognizing the sensitivity of housing and auto sales and a whole host of activities to interest rates, short and long term, given the recent pronouncement by the Federal Reserve on its policies and recognizing the uncertainties of the budgetary process here on the fiscal side, what would you anticipate will occur on the interest rates front? Will these interest rates stabilize now or can we hope that they may decline further?

LONG-TERM RATES COMING DOWN

Mr. FELDSTEIN. Well, I continue to believe that as we develop confidence that inflation is not going to be allowed to increase we will see long-term rates coming down. But I think it's going to be hard over the next 2 or 3 months to have any kind of substantial change in people's thinking about the longer term.

I think if the recovery is well underway, 6 months from now or 9 months from now, and inflation has not started going up at a significant rate, that will be very reassuring. But at the same time, Congress must have made major progress in bringing down the likely outyear deficits. The combination of those two things would make for a substantial reduction in long-term rates.

Senator TRIBLE. So are you saying then for the next several months you would anticipate interest rates would be stable?

Mr. FELDSTEIN. I would anticipate that long-term rates would not show any substantial movements over the next few months, but I will repeat what I said about exchange rates—forecasting is dangerous like that.

Senator TRIBLE. Chairman Volcker also testified that the Fed expects nominal GNP, total spending, to grow 8 to 9 percent this year with real growth in the range of 3.5 to 4 percent. Compare those projections, if you will, to those prepared for the administration's budget and tell us how the Fed projections would affect the Federal budget and the Federal deficit.

Mr. FELDSTEIN. Yes. Our forecast for the same period is 3.1 percent real growth. You said Chairman Volcker has said about 3.5 percent and maybe a little higher than that. The difference is really very, very small. The nominal GNP figure we have shows a little more inflation than theirs and so our projection of nominal GNP growth for the year is really very similar to theirs. The differences between these forecasts in terms of their impact on the budget deficit are a few billion dollars, under $10 billion or so. There's not enough difference to be worth thinking about at this time.

Senator TRIBLE. Well, you know, my constituents believe a billion dollars here and a billion dollars there still count, but I recognize in terms of triple digit deficits——

Mr. FELDSTEIN. Certainly in terms of the decisions that have to be made, we would be delighted if there were a little more economic growth. It would reduce the deficit a little bit, but it wouldn't in any way remove the requirement for the important changes that have to be made on both the revenue and the spending side.

Senator TRIBLE. I understand. I thank you and I thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

The administration is predicting 3.1 percent in growth this year, I think you told Senator Trible. I saw some figures the other day, Dr. Feldstein, which indicated that the economy would have to grow at the rate of 3.5 percent just to absorb new workers coming into the work force and also to compensate for unemployment caused by increased productivity—I suppose technological unemployment. Are those figures accurate?

Mr. FELDSTEIN. No. It's more like 2.5 percent that you need, 2.5 percent real growth to keep pace with productivity and the growing labor force. Our forecast of 3.1 percent indicates that there will be declining unemployment so that 3.1 percent is more than enough to offset the other.

Senator SASSER. But at 3.1 percent we're talking about a minimal decline in unemployment in the coming year. What are the unemployment figures? Aren't you still predicting in your economic forecast for the coming year unemployment of 9.9 percent? Am I correct in that figure?

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UNEMPLOYMENT FORECAST TOO PESSIMISTIC

Mr. FELDSTEIN. The forecast that we have for unemployment already looks too pessimistic, given the recent unemployment, but we have the unemployment rate only falling to 10.4 percent by the end of this year. As you know, those recent figures that we have had from the Department of Labor indicate 10.4 percent was the unemployment rate, by the old definitions, in January.

Now we have been warned and I'm sure you have heard that that 10.4 percent may have a certain amount of statistical error in it. Statistical noise frequently occurs during the winter months because of the difficulties of seasonal adjustments. So it's not out of the question that we will see that number bounce back up again.

But if the recovery is indeed underway and if it continues at a healthy pace, we would certainly expect to have a lower unemployment rate by the end of the year than we forecast, and certainly lower than we have today.

Senator SASSER. What sort of economic growth are you predicting for the outyears? In other words, my concern is if you're predicting a 3.1 percent growth for this year—and I think it's generally conceded now that the administration's predictions are perhaps overly pessimistic, which is refreshing after 2 years of unrealistically optimistic projections—but they are projecting 3.1 this year. Let's say that is unduly pessimistic and say the Fed's figures are more accurate, that it does get up to 4 percent or even 4.5 percent as some of the private prognosticators have been predicting. What are you predicting for the outyears?

Mr. FELDSTEIN. Let me first comment on the current year where we have emphasized that this forecast, like any forecast, reflected a balance of probabilities. Certainly at the time we made the forecast there was no evidence of a recovery having begun.

Now, a month and a half later, there is evidence that may turn out to be an indication that recovery has begun. Certainly if the recovery did begin in December or January then we would expect more than 3.1 percent for the year as a whole.

Now looking to the outyears, we have tried to avoid making precise year to year forecasts, trying to guess just which years will be up and which years will be down, and instead we have emphasized the average growth over the entire period. The average real growth that we're looking for over the entire 5-year period is 4 percent real GNP growth a year.

I might add, just to put that in some context, by comparison, over the last three decades the economy has grown at less than that, at about 3 percent. In the 1970's, it was a little more than 3 percent. Of course, we are talking about growth coming out of the bottom of a quite severe recession.

Six years from the trough of a recession, during the entire postwar period overall, the recoveries have averaged 4 percent real growth. What we are looking for is real growth which is about the same as has happened on average over that period, although the distinguishing feature is that we want to see that happen without an increase in inflation. Sustained recoveries in the past have always been spoiled by rising inflation.

Senator SASSER. Well, my concern is, Dr. Feldstein, with these growth figures that are being projected now, it appears to me that we are going to be sitting here 5 years from now still with very, very high unemployment figures. If we're going to grow here at the rate this year as you're predicting of 3.1 percent, or as others are predicting of 4 percent, and if we grow at the rate of 4 percent over the next 4 or 5 years, what's this going to do to our unemployment picture?

Mr. FELDSTEIN. We estimate that the unemployment out in 1988 will average about 6.5 percent, down to 6.2 percent by the end of 1988. Now I would certainly like to see lower unemployment than that, but I'm afraid that given our current labor markets that 6- to 7-percent range for unemployment is about as low as you can get without putting upward pressure on wages and prices.

Senator SASSER. At that unemployment figure, at 6.5-percent unemployment, if we just let things go the way they are now with regard to the budget, if current policy remains in effect, what would be the structural deficit built into this budget?

Mr. FELDSTEIN. The deficit out in 1988 would be essentially all structural and it would be about $300 billion or 6 percent of GNP, totally unacceptable.

Senator SASSER. Totally unacceptable—even if we get down to your best unemployment figures there and the economy is as healthy as you predict it can be, we are still going to be running deficits of $300 billion a year?

Mr. FELDSTEIN. Those two things are incompatible. We could not have this kind of economic growth and we could not have this kind of recovery if we don't make the kind of changes called for in the President's budget. We must shrink those deficits to something down to something more manageable and more tolerable.

Senator SASSER. Throughout your testimony you state that monetary targets should be calibrated to the pursuit of a moderate GNP growth. We have had the Fed monetary targets since 1979, and GNP has remained virtually stagnant now for a period of 3 years or almost 3 years.

What does this say about the Fed's monetary targets and their impact on GNP growth?

Mr. FELDSTEIN. Well, let me emphasize that we are at nominal GNP growth.

Senator SASSER. Let me just ask you this if I may. Would you have stuck with these monetary targets that the Fed used between 1979 and 1982?

Mr. FELDSTEIN. I would say that basically the Fed has done a good job. They haven't precisely stayed with their own targets. They allowed both M_1 and M_2 to rise above target a bit last year because they saw this very sharp change in velocity which was keeping the nominal GNP growth much below what might have been anticipated. And I would say that the targets that they have set now for 1983, as best as we can tell at this point, are consistent with a healthy growth in nominal GNP.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

I'm sorry, Dr. Feldstein, that we have not had a chance to say hello. I missed your testimony this morning, and I was looking forward to it. I greatly admire your views and what you're trying to accomplish under what I think are very difficult circumstances.

I will just take a minute, if I might, and search out answers to a couple of things that I'm interested in. I did hear you say, and you confirmed what we have heard from some and disputed by others, that such things as long term fixed rate mortgages are going to be difficult to borrow as in other times. Some have said that they see a trend back to that kind of thing. Others like Chairman Volcker said that 50 percent of the mortgages being issued were of that character.

How do you feel about the future of the mortgages? Do you see more money going into fixed-rate, long-term mortgages?

Mr. FELDSTEIN. Well, I think that, as I said before, borrowers still like to have a sense of certainty about what their payments are going to be.

Senator LAUTENBERG. What about lenders?

VARIABLE RATE MORTGAGES

Mr. FELDSTEIN. And lenders also like to have some sense that they are going to be repaid in real terms in an amount consistent with what they have lent out. And I have long favored moving more in the direction of variable rate mortgages and tried to design them in ways that gave more latitude than the current regulations permit so that it becomes easier to have small changes in the year to year fluctuation of payments while allowing substantial change in the interest rates by changing the repayment period, for example.

Obviously, the more we have to live with inflation, with uncertain inflation, the more important it is to reshape financial instruments in that way. But it would be a lot better if we didn't have the fear of inflation and if people could have the kind of instruments that both borrowers and lenders are more comfortable with.

Senator LAUTENBERG. Since forecasting is part of your profession and your business, do you see us getting more into the long-term fixed-rate market or less so?

Mr. FELDSTEIN. It depends very much on what happens to perceptions of inflation. The Europeans have moved further and further away from fixed-rate markets, long-term fixed-rate markets, because inflation has become so unpredictable there. If we come back to a more predictable inflation environment, I think we will see a redevelopment of the long-term market of a conventional sort.

Senator LAUTENBERG. Those perceptions affect the security of the lenders very significantly and very few of them, in my view, want to be out for 25 or 30 years now on a 25-year rate. The reason I asked about that is because I think that has a material effect on the housing market which is a very serious part of our economy, and although we are all buoyed somewhat by the encouraging statistics, I wonder how realistic they are and what the shape of things in that market are. We have heard that there are small units being built and that there's a lot of building going into areas that are quite far removed from the place of employment thus cre-

ating problems of extra transportation. I wondered whether you thought there was any influence on lending capability as a result of the type of money instruments that are now available, the Super NOW's and all that, and I'd just briefly like to see whether you think these things are healthy in terms of being able to stabilize our economic growth and thus have a kind of free flow of funds toward a better inflation control or perhaps even lesser inflation control, and thus the ability to forecast mortgage terms and things of that value.

Mr. FELDSTEIN. Well, speaking of the mortgage market, I think the development in the last few years has been a very healthy trend, making the mortgage market more a part of the overall national capital market and breaking down some of the previous barriers. Developing the mortgage backed bonds, for example, gives housing a chance to compete with bonds on a more equal basis and not be subject to the problems of disintermediation that have occurred in the past.

Similarly, the regulatory changes will now keep the financial institutions in a position where we will not see these large disintermediating shifts of funds crunching down on the housing market. If we combine that with floating rates, then we can have a more stable housing industry than we have had in the past.

Senator LAUTENBERG. Fewer people, however, I think are able to make the commitment to purchasing a home under that kind of flexible arrangement. I do think that for the average home buyer, for the more modest home purchaser, that it's very difficult for them to take on a mortgage commitment that they know may vary in terms of their costs.

Mr. FELDSTEIN. Well, I think that's what I was referring to before. It's important to allow interest rates to move up two or three points but we can't have a corresponding proportion of the monthly payment go up. One way of dealing with that is to allow the repayment period of the mortgage to change. As interest rates fall, it's spread out shorter.

Senator LAUTENBERG. Someone with a 25-year mortgage winds up with a 40-year mortgage?

Mr. FELDSTEIN. That's what the British have done. They have allowed the repayment period to vary. I think their ruling monthly payments are allowed to go up with inflation, but not with the interest rate, and they are not allowed to be too small to keep current on interest. But they don't have to actually be amortizing the mortgage at any time.

Senator LAUTENBERG. The smile came because I thought immediately of guaranteeing a lifespan that would correspond with the length of the mortgage.

With regard to the unemployment statistics, those which you offer, I believe 6.2 in 1988——

Mr. FELDSTEIN. Again, I have to caution you about the uncertainty of forecasting what the unemployment rate is going to be in 4 or 6 years, but that's what's implied by our forecast of continuing at a 4-percent growth.

Senator LAUTENBERG. Before I obtained this responsibility in the Senate, I was in a business that sold as part of its product economic forecasting, both the Chase econometric products and then the

Townsend-Greenspan products, and there may be some philosophical difference along the way and I know some of the vagaries and, therefore, I will not hold you to anything here on the public record, but what about the growth of the work force as well? When we look at 6.2 percent unemployment aspirations. For instance—and that's not good enough we both acknowledge—is that the percent of the work force that's about the same size?

Mr. FELDSTEIN. No; the work force is substantially higher. We are talking about 15 million more people working in 1988 than are working today. So part of that, about 4.5 million, I suppose, would be a reduction in unemployment taking it from 10.4 to 6.2. The rest of that 15 million growth would reflect growth of the labor force and the ability to employ a larger labor force.

Senator LAUTENBERG. So those who are unemployed would be structural?

Mr. FELDSTEIN. That unemployment would be structural.

Senator LAUTENBERG. Structural and longer term unemployed workers. More than half of that would be the young people, people under the age of 25, who are still in the process of trying to make a permanent attachment to the labor force. I think we have to continue to develop labor market policies to reduce that kind of unemployment.

Senator LAUTENBERG. Fine. I've been trying to fish out from the various witnesses over the past couple days—whether or not there is any concern or negative view on the volatile money instruments that are so readily available. The investors or savers are much more sophisticated today and you see this rapid movement from one type of monetary classification to another, and I sense that it's a bit stabilizing for the institutions as well as the general management of the money supply and the economy.

Mr. FELDSTEIN. Well, there certainly are problems associated with deregulation. But we have to pay a certain price in terms of uncertainty and difficulty of monetary management to get out from a set of regulations that it is widely agreed have outlived whatever purpose they might have served. I think we are doing the right thing and that the Congress did the right thing in adopting the deregulatory changes that they made last year, even though they do make monetary policy more difficult at this time.

Senator LAUTENBERG. Thank you.

The CHAIRMAN. I have many additional questions for you which I will submit in writing, but I'm also aware that you have to testify before another Senate committee shortly and so I will let Senator Proxmire do the cleanup today.

Senator PROXMIRE. Well, I'm just going to ask a couple questions very quickly. One follows up what Senator Lautenberg was asking about.

7-HOUR WORKDAY

If we are going to have 6.5 percent of the work force out of work after a 6-year recovery, it would be almost an unprecedented period of recovery even though it's a recovery at a modest rate. I'm pretty sure what your reaction is going to be to this, but it seems to me we ought to think about sharing the jobs we have. You're right

about the increase in the work force. We haven't had a change in hours of work per day for 50 years. We accommodated to that pretty well after we modified the hours of work. If we gradually went to a 7-hour day, obviously you would have more jobs. If we had double time for overtime you would have, from the best documents I've seen, about maybe 4 or 5 million jobs depending on how you figure it.

I realize that there are all kinds of costs you have to bear with that and I'm not advocating it in any way, but I think it's something we might think about in view of the gloomy notion that we're going to have a lot of people out of work 6 years from now even.

Mr. FELDSTEIN. I'm glad you're not advocating it.

Senator PROXMIRE. I'm not opposing it. I think you ought to look at it.

Mr. FELDSTEIN. Well, I would oppose that. I don't think it really deals with the problem. The problem is that more than half of that 6.5 percent unemployed that are going to be young people for whom we have to find a better way into the system. Many of those are people looking for their first job, coming out of school, and the transition from school to work just has to be improved. Many of them find jobs, lose them, take a little time off, find another job, lose it, rather than finding a way of getting into a job with more of a future.

Senator PROXMIRE. Nobody has argued that 6.5 percent is a frictional level of unemployment. We had less than 1-percent unemployment, if we included the Armed Forces, in 1944. Of course, we had a lot of controls. It seems to me that's a pretty high level. Japan has 2 percent. 6.5 percent is a pretty high level.

Mr. FELDSTEIN. Absolutely. I'm not saying it's a necessary level. I'm saying I agree with you that we ought to be devoting more resources and thinking harder about how to bring it down. I just don't think job sharing in the conventional sense or shorter hours will do it. I think it's improving the work in the labor market and removing some of the disincentives and barriers that stop different kind of workers from staying employed longer. Reducing our whole system of temporary layoffs would substantially reduce what could be called frictional unemployment, which is almost uniquely a North American labor market characteristic. We need to find ways to keep those workers employed such as better inventory methods and better incentives for employers.

Senator PROXMIRE. Very good. The only other question I have is that isn't it kind of ridiculous for us to talk about any kind of a jobs stimulus program on top of what we have. We face a colossal increase in the deficit. Talk about stimulus—we go from $108 billion to $200 billion, a perfectly enormous effect that way. It seems to me that almost any other kind of stimulus is going to have extraordinary effects the other way. If anything, a stimulus in the long run must be viewed, it seems to me, as much, much too big. If John Maynard Keynes could be recreated and come back here and take a look at this, he would say, "You folks have gone too far. I was talking about stimulus in periods of recession. To go from $100 to $200 billion, that's just too much." What's your reaction?

Mr. FELDSTEIN. I agree completely. I go and testify next at the Senate Finance Committee and talk about unemployment. I'll read one sentence from that in which I argue against Keynesian stimulative measures at this point and say even the most ardent Keynesian is likely to feel that a budget deficit of more than $200 billion in 1983 represents sufficient fiscal stimulus. I think there is no case for additional fiscal stimulus at this time and the danger is that anything that appears to add permanently to our deficit will be interpreted by the markets as a sign that Congress is not serious about reducing the outyear deficits. That in turn will lead to higher interest rates and be counterproductive.

Senator PROXMIRE. Thank you.

The CHAIRMAN. May I say in closing that I agree with both of you. Not only is $200 billion not stimulus but my experience in the time I've been here and I'm sure Senator Proxmire's too who's been here much longer, when we come up with stimulative jobs program they're almost always at the end of the recession.

Mr. FELDSTEIN. It is one of the good leading indicators of recovery.

The CHAIRMAN. If we were going to do them maybe 2 or 3 years ago might have been the time to do them.

Thank you very much.

Next we'd like to invite before the committee Mr. Andrew Brimmer, president, Brimmer & Co.; John D. Paulus, chief economist and vice president, Morgan Stanley & Co. of New York; and J. Richard Zecker, senior vice president and chief economist, Chase Manhattan Bank of New York.

Gentlemen, we are pleased to have you before the committee today. We would appreciate it if you would summarize your statements. Your entire statements will be included in the record and, Mr. Brimmer, if you would like to start off we would be pleased to hear you at this time.

STATEMENT OF ANDREW F. BRIMMER, PRESIDENT, BRIMMER & CO., WASHINGTON, D.C.

Mr. BRIMMER. Thank you very much, Mr. Chairman.

Senator Garn, Senator Proxmire, and the committee, I did file ahead of time a copy of my statement. If you would permit, Mr. Chairman, if you would put that in the record, I would appreciate it. I would summarize the content very quickly.

Let me say at the outset that I want to praise the Federal Reserve for the posture it's just taken with respect to the conduct of monetary policy. I believe that the requirements of monetary policy are clearly enunciated. What we need is a monetary policy that continues to assure that we will not have a rekindling of inflation, but at the same time, also makes a contribution to the strengthening of an economic recovery that is still quite uncertain. The Federal Reserve has indicated that it would plan to do that.

I would also want to emphasize that the outcome of this recovery will depend substantially—and I want to stress that—will depend substantially upon the actual performance of the Federal Reserve—aside from the announced posture the Board has just taken.

[Complete statement follows:]

MONETARY POLICY AND THE ECONOMIC OUTLOOK

Testimony By

Andrew F. Brimmer*

Mr. Chairman and Members of the Committee, I was pleased to receive the invitation to comment on Federal Reserve monetary policy and its likely effects on the American economy during the rest of this year. Since these Hearings are being held under the terms of the Full Employment and Balanced Growth Act of 1978 (also known as the Humphrey-Hawkins Act), I will focus particularly on the target set by the Federal Reserve for the growth of the monetary aggregates during the current year. I will also give my appraisal of the outlook for employment.

Before turning to that analysis, I wish to say at the outset that I believe the recovery from the severe recession that has burdened this country since mid-1981 is finally underway. At the same time, however, the underpinnings of the economic recovery remain extremely fragile, and the vigor of the expansion during the remainder of this year continues to be uncertain. Moreover, whether the expansion will gain strength or begin to sputter before the end of the year will depend substantially on the level of interest rates and the availability of credit. The latter, in turn, will depend on the course of monetary policy adopted by the Federal Reserve.

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* Dr. Brimmer is President of Brimmer & Company, Inc., a Washington, D.C. -based economic and financial consulting firm. From March, 1966, through August, 1974, he was a Member of the Board of Governors of the Federal Reserve System.

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Outlook for Economic Activity

The accumulating evidence suggests that the American economy is beginning to pull out of the worst recession since 1937. In the final quarter of 1982, gross national product corrected for inflation (real GNP) fell by 2.5 per cent at a seasonally adjusted annual rate (SAAR). Over the full year real output shrank by 1.9 per cent. Actually, at the end of 1982, real output in the United States was no higher than it was at the peak of activity in the first quarter of 1980. Furthermore, when actual output is compared with what could be produced when the economy is working at full employment, the stagnation of the economy over the last three years stands out dramatically. The shortfall accumulates to approximately $450 billion in real GNP. On a per capita basis, real GNP decreased from $6,707 per person in 1979 to $6,348 in 1982 - equal to a decline of 5.4 per cent.

In one sense, the 1980 and 1981-82 recessions really represent a single episode. The sharp decrease in output in 1980 was followed by only a very modest expansion through the summer of 1981. At that juncture, the recession began and it extended through the end of last year. All major sectors contributed to the sub-par performance of the economy, but those segments that are highly sensitive to interest rates (such as housing and automobiles) bore the brunt of the adverse impact of the recession.

During the current year, it appears that real GNP might increase by about 2.5 per cent compared with the level recorded in 1982. From the fourth quarter of 1982 through the same period this year,

the rise in real GNP might amount to around 4.3 per cent. Compared with the rebound from previous recessions, the expansion that is now expected during the first year of recovery would be rather anemic. For example, assuming that expansion in economic activity does get underway during the current quarter, over the first twelve months of recovery, the increase in real GNP may amount to roughly 4.0 per cent. This figure would represent just over half the rate of expansion recorded during the first year of recovery from previous recessions.

The strengthening of economic activity now anticipated for the current quarter will be led by housing and the consumer sector. However, personal income adjusted for taxes and inflation (real disposable income) is likely to show very little strength until mid-year. This is a mirror of the adverse effects of widespread unemployment on the growth of wages and salaries. Any significant gain in real disposable income will have to await the final phase of the income tax reduction scheduled for July of this year. Given that prospect, real consumer spending might rise by just over 2½ per cent in 1983.

Outlook for Major Sectors

As mentioned above, the housing sector has borne the brunt of high interest rates over the last few years. In 1982, 1.060 million new units were started. This was a drop of 3.6 per cent from the previous year. To meet the long-term housing needs of the country, roughly 2.0 million

units should be begun each year. This means that, over the last three years, the shortfall in home production amounts to about 2.5 million units - a loss equal to over two-fifths of potential output.

The linkage between high interest rates and the housing sector is widely understood. The sharp rise in interest rates resulting from the Federal Reserve's restrictive monetary policy - pursued from October, 1979, into the summer of 1982 - cut the inflow of funds to savings and loan associations (S&L's). These institutions still serve as the principal source of home financing. In response, mortgage interest rates also rose dramatically. The increase in the latter outstripped the advance in disposable personal income, so the number of would-be home buyers who could qualify for mortgages shrank appreciably.

During the current year - if the Federal Reserve maintains its essentially accommodative policy - deposits at S&L's might expand by 12.8 per cent (from $554.2 billion to about $625.0 billion). This would be a considerable improvement over the 6.3 per cent gain recorded last year. In that environment, the average interest rate on conventional mortgage commitments would probably be in the range of 13.0 to 13.5 per cent. The average for 1982 was just under 16.59 per cent. The somewhat lower rate in the current year should permit new housing starts of approximately 1.45 million units. At that level, homebuilding activity would expand by roughly

39 per cent in 1983.

The automobile industry will also benefit somewhat from lower interest rates in the current year. Retail sales of new cars might come to 8.8 million this year. About 6.6 million may be domestically produced, and 2.2 million may be imports. This would put the import share of the U.S. market at 25.5 per cent. In 1982, 8.0 million cars were sold in this country. United States manufacturers produced 5.7 million units, and 2.2 million were imported - which gave the latter 28.2 per cent of the U.S. market.

The high interest rates over the last few years have had a noticeably dampening effect on the rate of capital formation. For example, over the three years ending in 1979, real expenditures for business fixed investment expanded at an annual rate of 2.8 per cent. But over the following three years, the level of real investment was essentially stagnant. In 1982, real investment actually shrank by 3.8 per cent.

In addition to high interest rates, the large backlog of excess capacity in industry has also weakened the incentive to invest in new facilities. At the peak of economic activity in the first quarter of 1980, the capacity utilization rate in manufacturing was 83.4 per cent. But, by December, 1982, the utilization rate had decreased to a record low of 67.3 per cent. In January, 1983, it rose 0.5 percentage point to 67.8 per cent.

In 1983, real outlays for fixed investment may decline further - by perhaps as much as 7½ per cent. Spend-

ing for equipment might decline by approximately 6.0 per cent over the full year - although positive growth may begin in the third quarter. However, outlays for commercial and industrial construction will probably decline throughout the current year. For the year as a whole, the decline might amount to more than 10.0 per cent. This deterioration is probably a reflection of the large margin of unused space left by the office building boom of the last few years.

Prospects for Jobs

The labor market will probably show very little improvement during the current year. From the fourth quarter of 1982 through the same period this year, the civilian labor force might rise by roughly 1.7 million persons. Over the same period, total employment might rise by 2.0 million (to 101.1 million). This improvement would reduce the level of unemployment by approximately 300,000 persons (from 11.8 million to 11.6 million). This would mean that the unemployment rate would decrease from 10.7 per cent in the fourth quarter of 1982 to about 10.3 per cent at the end of this year.

Further Abatement of Inflation

In 1982, inflationary pressures in the economy abated considerably. For example, the gross national product (GNP) deflator (the most broadly based of the various price indexes) rose by 6.0 per cent. The consumer price index (CPI) increased by 6.1 per cent. Moreover, in the closing months of last year,

the GNP deflator rose by 4.3 per cent (SAAR), and the CPI rose by 2.6 per cent (SAAR). In marked contrast, in 1981, inflation was in the neighborhood of 9½ to 10½ per cent.

To a considerable extent, the slowdown in inflation can be traced to the recession-induced weakness in the economy. The latter, in turn, can be traced to the policy of severe monetary restaint followed by the Federal Reserve.

Over the next year or so, the recent abatement in inflationary pressure is not likely to be erased. The large measure of excess capacity in industry (which is likely to remain for some time) means that production can be increased substantially without running into the type of shortages and bottlenecks which would generate upward pressure on prices. Moreover, the low level of economic activity (not only in this country but in the world at large) will continue to dampen the demand for oil. This means that there is little prospect of a sharp boost to inflation from this source.

In addition, the underlying rate of inflation (reflected in the tendency for increases in compensation to exceed gains in productivity) will probably remain moderate for quite some time. The major concessions on wages and benefits which numerous strong trade unions have made over the last two years are not likely to be withdrawn quickly. Consequently, the rate of increase in labor costs will also most likely remain quite moderate. This, too, will help to ease any upward

pressure on prices.

Given that outlook, the rate of inflation will probably moderate further during the current year. Both the GNP deflator and CPI might rise by roughly 5.0 per cent. Wholesale prices might advance by about 4 per cent, and wages and benefits might increase by 5.8 per cent. The latter would mean a further easing in the underlying rate of inflation - to about 6.2 per cent.

Federal Government Fiscal Policy

The outlook for the Federal Government's budget is extremely discouraging. In fiscal 1982, Federal budget outlays rose by 10.8 per cent to $728.4 billion. In the same year, budget receipts increased only 3.1 per cent to $617.8 billion. So the deficit jumped by 91.2 per cent to $110.6 billion. These changes raised outlays to 23.8 per cent of GNP while the deficit climbed to 3.6 per cent of total output. The budget as finally adopted by Congress for fiscal 1983 projects budget outlays at $805.2 billion and receipts at $597.5 billion - leaving a deficit of $208.7 billion. These estimates would leave budget outlays and the deficit at 25.2 per cent and 6.5 per cent of GNP, respectively.

During the period of substantially reduced economic activity over the last two years, the Federal deficit helped to prevent demand from falling as much as cutbacks in private spending would have brought about. At the same time, however, the deficits have exerted considerable pressure on the money

and capital markets. For example, in 1981 net borrowing by the Federal Government amounted to $77.8 billion. The amount of funds raised by all sectors came to $408.7 billion. So the Federal Government absorbed 19.0 per cent of the total.

The magnitude of Federal Government deficit finances increased dramatically in 1982. Net borrowing by the U.S. Treasury came to $150 billion while the amount of funds raised by all sectors is projected at $400 billion. These figures suggest that the Federal Government absorbed 37.5 per cent of the funds raised in the capital market last year. Furthermore, net Federal Government borrowing in 1983 is projected at $195 billion, and total borrowing is estimated at $456 billion. Under this scenario, the Federal Government would still be absorbing 42.3 per cent of the total funds raised by all economic sectors.

Federal Reserve Policy and Interest Rates

As indicated above, the outlook for economic activity and interest rates during the current year will be influenced greatly by the monetary policy pursued by the Federal Reserve. And in that connection, it is well to note that the Federal Reserve has just reemphasized its commitment to continue its campaign to check inflation and to eradicate inflationary expectations that are still deeply-rooted in many sectors of the economy - and not simply in financial markets. At the same time, however, the Federal Reserve has also indicated that monetary policy

will be used to help assure the strengthening of economic recovery.

In the meantime, the central bank has also expressed its willingness to tolerate the growth of the monetary aggregates at rates in excess of their long-range targets (which must be set each year as required by the Humphrey-Hawkins Act). It will be recalled that, from the fourth quarter of 1981 through the fourth quarter of 1982, the range for the narrowly defined money supply (M1) was 2½ to 5½ per cent. For the broader money supply (M2) the target range was 6 to 9 per cent. For M3, the range was 6½ to 9½ per cent, and for bank credit the range was 6 to 9 per cent. The record shows that the actual growth rates for each of the money supply measures exceeded the targets - with the excess growth in M1 being especially noticeable. Before the statistics were revised (to take account of benchmark revisions and definitional changes), M1 rose by 8.3 per cent; the increase in M2 was 9.8 per cent, and M3 rose by 10.3 per cent. After the revisions, the growth rates were 8.5 per cent, 9.2 per cent, and 10.1 per cent, respectively. The expansion of bank credit (both before and after revisions) was 7.1 per cent.

To a considerable extent, the expansion in the monetary aggregates (especially a rise in M1) reflected a number of dramatic innovations in the financial system. For example, the expiration of "All Savers" certificates led many households to place the proceeds - at least temporarily - in their checking accounts. The rapid deregulation of ceilings on interest rates payable by

financial institutions was matched by the proliferation of a variety of high yielding deposit accounts. This led to considerable turmoil as funds were shifted from money market accounts to banks and other depositary institutions - as well as among the latter. These developments created a great deal of distortion in the statistical measures of the monetary aggregates, and the adjustments are still underway.

Moreover, the high level of unemployment, strains in the financial system, and general uncertainty associated with the long recession, all combined to expand the public's demand for liquidity. This latter development also contributed to the growth in the monetary aggregates in excess of the Federal Reserve's targets.

The Federal Reserve chose to accommodate the increased demand for liquidity, and it also decided not to try to offset the growth in the monetary aggregates induced by the financial innovations described above. Both of these were wise decisions. If the Federal Reserve had attempted to force the growth rates of the monetary aggregates back into the target ranges adopted in early 1982, the necessary restraint on bank reserves would have been so great that the economy would have been pushed even more deeply into recession; the eventual recovery would have been delayed further, and the subsequent expansion would have been even more anemic.

For the current year, the Federal Reserve has widened the target range for the growth of M1 from 4 to 8 per cent compared with a range of 2½ to 5½ per cent set for 1982. However, because

of the distortion described above - as well as because of a marked change in the behavior of velocity - the Federal Reserve has indicated that it will put less weight on M1 as a guide to policy in coming months. That too is a wise decision.

For the time being, the broader measures of the money supply (particularly M2) will serve as the principal guides for the implementation of monetary policy. In the case of M2, the boundaries for the growth rate were set at 7 to 10 per cent. In addition, the base against which growth is to be measured was shifted from the fourth quarter of 1982 to the average of February-March, 1983. This move was designed to avoid much of the distortion created by the shifting of funds into newly authorized accounts in December and January. The growth targets for M3 were reestablished at 6½ to 9½ per cent - the same as last year. The base for comparison remains the fourth quarter of 1982. This decision was made on the assumption that M3 would be less affected by the statistical distortions described above.

Finally, the Federal Reserve has introduced a new measure which will be given some weight as a guide to monetary policy. This is a measure of total domestic nonfinancial debt. The target range for the growth of this debt was set at 8½ to 11½ per cent for 1983. Although this measure was not adopted as a firm target, the Federal Reserve does plan to track it during the course of the year. A considerable body of research conducted by private economists does suggest that nonfinancial debt does expand roughly in line with nominal GNP. Consequently,

the use of this measure should enable the Federal Reserve to tailor its monetary policy to help meet the credit needs of the economy during the years ahead.

Concluding Observations

In conclusion, the posture adopted by the Federal Reserve with respect to the conduct of monetary policy during the current year is appropriate. The greatly improved prospect for inflation - and the persistance of an uncertain outlook for economic recovery - does give the Federal Reserve a considerable margin of safety within which to carry out an accommodative monetary policy through the balance of this year. It also means that such a policy is unlikely to spark the kind of strong inflationary pressures which the Federal Reserve has sought to check over the last several years.

On the other hand, the threat of rekindling inflationary expectations still exists. A number of market participants are apprehensive because they fear that above-target growth of the money supply (which the Federal Reserve has tolerated since last summer and appears willing to accept for some time into the future) will eventually lead to inflation. An additional reason is the persistence of large federal budget deficits (in the neighborhood of $200 billion. per year) extending well into the future. The need to finance these deficits has cast a shadow over the nation's financial market. Anticipating the enormous Government demand for funds, investors in long-term securities (especially pension funds and other institutional

investors) have modified their portfolio strategy accordingly. They are afraid that the large deficits will stimulate renewed inflation and exert upward pressure on long-term interest rates. This expectation has induced them to concentrate a disproportionate share of their currently available funds in short- and medium-term issues. This action helps to validate their expectations of higher yields on long-term securities.

These expectations have also contributed to an exceptionally high level of real interest rates - that is, nominal interest rates minus the rate of inflation. Over the last several years, real rates have risen substantially. If such rates are measured by the differential between yields on long-term AAA public utility bonds and the rate of inflation (measured by the 12-month change in the implicit deflator for personal consumption expenditures), the real rate climbed from 3.4 per cent in 1976 to 9.1 per cent in 1982. The sharp rise in the real rate resulted initially from the fact that interest rates (after lagging for a while) eventually climbed much more than the rate of inflation. Subsequently, once inflation began to abate in mid-1982, interest rates also receded, but the decrease was less than the moderation in inflation. As a result, the real rate on long-term corporate bonds was still over 7.0 per cent at the end of last year.

Nevertheless, despite the pessimistic expectations of market participants, the Federal Reserve ought to stay with its accommodative monetary policy through the current year. It should keep in mind the expectations currently held by other important elements in the economy. These are the key officials in industry and commerce who make the decisions affecting real output, capital formation, and the creation of jobs. They need - and expect - lower long-term real interest rates to help stimulate and sustain economic recovery. To enhance the prospect of achieving this goal, the Federal Reserve should stay with its policy of lessened restraint for a while longer.

The CHAIRMAN. Thank you, Mr. Brimmer.
Mr. Paulus.

STATEMENT OF JOHN D. PAULUS, CHIEF ECONOMIST AND VICE PRESIDENT, MORGAN STANLEY & CO., INC., NEW YORK

Mr. PAULUS. Thank you, Mr. Chairman.
[Complete statement follows:]

Testimony of John D. Paulus

Chief Economist, Morgan Stanley & Co., Inc.

before the Committee on Banking, Housing and Urban Affairs,

United States Senate

February 16, 1983

I am pleased to have the opportunity to comment on the conduct of monetary policy before the Committee on Banking, Housing, and Urban Affairs. I will consider principally the following question: How stimulative has monetary policy become? The related issue of the prospective level of interest rates that might be consistent with a sustainable economic recovery also is discussed.

Evidence and arguments supporting the following statements will be presented:

(1) In recent months the monetary aggregates have been unreliable indicators of the effect of monetary policy on the economy. Monetary policy has been less stimulative then the aggregates would seem to imply. With the process of cyclical recovery just beginning, the likelihood of a significant rise in interest rates over the next few months, therefore, is small.

(2) The Federal Reserve must take account of the difficulty of raising interest rates after recovery has begun, but unemployment is still high, in determining how low to move rates before a recovery is assured. Letting rates drift too low could lock monetary policy into too stimulative a stance if the economic recovery is unexpectedly strong.

(3) Despite the fact that real interest rates still are high by historical standards, they probably have dropped enough to produce at least a modest economic recovery. This does not, of course, rule out further declines in short-term interest rates.

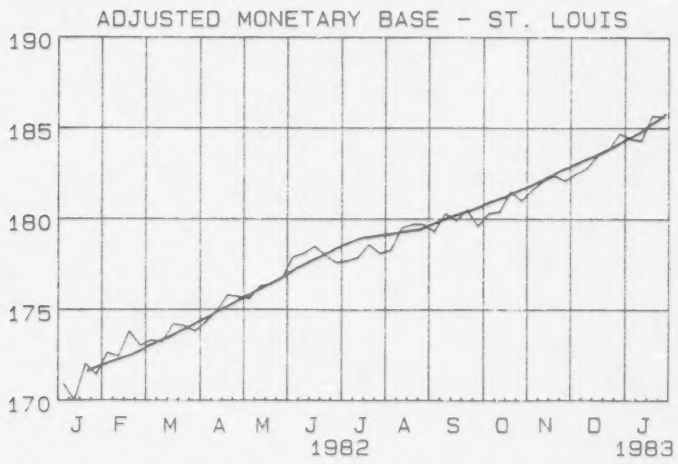
I The Monetary Aggregates As unreliable Indicators Of Monetary Policy

The upsurge in monetary growth in recent months has raised concerns that monetary policy has become excessively stimulative. This in turn has aroused fears in the credit markets that interest rates soon could be moving significantly higher.

An uncritical reading of the performance of the monetary aggregates would support the view that policy has moved sharply toward stimulus. Growth in the monetary base accelerated late in 1982, M-1

has grown at a double digit pace during the last half dozen months, and M-2 had overshot its target in 1982 before exploding last month. But there are persuasive reasons for ignoring, or discounting, much of this growth.

The monetary base has not been a reliable indicator of the effect of monetary policy on the economy. Shown in Figure 1 is the weekly level of the base for 1982 and January, 1983. The free hand line is drawn to smooth the week to week zigs and zags in the base. The slope of this line -- representing the growth rate of the base -- was essentially unchanged over the 13 months shown. Indeed, base growth, as shown in the chart, suggests that monetary policy was no different in the second half of 1982 than in the first half. Given the inability of the base to capture the significant alteration in policy that began in August, base growth hardly can be taken seriously as an indicator of the degree of ease or restraint in monetary policy.



Similarly the most reliable of the aggregates, M-1, has virtually broken down as an indicator of monetary policy. It is true that M-1 grew at a 17% annual rate in the fourth quarter of 1983 and grew strongly last month. But it appears that much of the growth in M-1 was due not to a build up of transactions balances (i.e. money to be spent), but to an inflow of investment funds into M-1. After adjusting for this inflow, recent M-1 growth does not appear excessive.

Inflows of nontransactions balances into M-1 can be estimated by determining how fast the demand for transactions balances by the public should have grown, given actual changes in spending and interest rates, and comparing that growth rate with the actual. Such a comparison is shown in Table 1. Using a standard demand for money equation,[1] -- which relates the public's demand for money to inflation, real GNP, and short-term interest rates -- it appears that less than half of the 17% growth in the fourth quarter can be attributed to a buildup in transaction balances. The rest represented inflows of nontransactions balances (such as maturing all-savers certificates being rolled into NOW accounts and savings monies moving into NOWs). But that portion of the growth of M-1 that was due to such inflows

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[1]The equation used was:
$\log \frac{m}{p} = .54 + .74 \log \frac{m-1}{p} - .012 \log RTB - .013 \log RS + .13 \log y$
where m/p is real money balances, RTB is the 3-month Treasury bill rate, RS is the rate on passbook savings, and y is real GNP. The equation was fit from 1960, fourth quarter through the second quarter of 1974. The "simulated" growth rates for 1982 shown in Table 1 are based on a dynamic simulation of this equation.

TABLE 1

ACTUAL VS SIMULATED MONEY GROWTH
(Percent Growth, Annual Rate)

	Actual Growth	Simulated Growth	Net Inflows Of Nontransactions Balances
1982-I	10.8	7.1	3.7
1982-II	3.3	7.1	-3.8
1982-III	3.5	8.2	-4.7
1982-IV	17.1	7.9	9.2
1982 (QIV-QIV)	8.7	7.6	1.1

has little to do with current and future spending plans and, in principle, should not be counted as a part of "true", M-1 growth.

The outsized growth of M-2 in January, of course, was largely attributable to a massive inflow of funds into the new money market accounts (MMA's) from financial assets not included in M-2. But even before MMA's were introduced, M-2 had become an entirely unreliable indicator of monetary policy. Before six-month and small saver certificates were introduced 1978 and 1979, and before money market funds became popular in 1979, a tighter monetary policy could be expected to result in a slowdown in M-2 growth, and an easing in policy a speedup, as movements in market interest rates around bank deposit ceilings produced either disintermediation or reintermediation.

However, despite the progressive tightening of monetary policy and higher interest rates in 1979, 1980 and 1981, M-2 growth accelerated from 8.2% in 1978 to 8.4% in 1979, to 9.2% in 1980 and to 9.5% in 1981. In 1982 M-2 grew by 9.8%. If anything M-2 has become a perverse indicator of monetary policy, rising more rapidly when policy is tightened.[2] Consequently, rapid growth in M-2 should not send chills, as it sometimes has of late, through the financial markets.

Thus, the recent strong growth of the major monetary aggregates does not necessarily imply that monetary policy has become excessively stimulative. In fact, there are good reasons for doubting the reliability of the aggregates in recent months in reflecting the degree of ease or restraint in monetary policy. To obtain more conclusive evidence on just how stimulative monetary policy has become it is necessary to examine other, nonmonetary, indicators of policy.

II Some Key Nonmonetary Indicators Of Policy

Ultimately, of course, the most meaningful measure of the effect of monetary policy on the economy is the growth rate of nominal GNP. It now appears that real GNP will expand in the first quarter as both autos and housing rebound from their depressed fourth quarter levels and inventory liquidation abates. Nominal GNP therefore should rise

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[2] Growth in M-2 appears to be influenced by changes in the savings rate and the unemployment rate. When the savings rate rises, the pool of savings is enlarged and M-2 grows more rapidly. When the unemployment rate rises, individuals, perhaps fearing job losses, desire to increase their liquidity. This too raises M-2 growth. But when monetary policy is tightened, both the savings rate and the unemployment rate tend to rise, sending M-2 growth up.

at its most rapid pace in over a year during the current quarter. However, the likely increase -- 8% or 9% at an annual rate -- is not particularly rapid for the first quarter of an economic recovery.

Moreover, only partial data are available for estimating GNP growth. Hence it is helpful to examine other nonmonetary indicators that are available on a more timely basis in trying to come to a judgment on the current degree of stimulus in monetary policy.

Four such indicators are displayed in Table 2: real interest rates; private borrowing (divided by GNP); percent changes in commodities prices; and the foreign exchange value of the dollar (March 1973= 100). Current values of the indicators are shown in the first column of the table. For comparison, in the second column is shown the average value of each indicator during the trough quarter and the first quarter of recovery of each of the last three recessions. In the third column are values of the indicators during the 1976 to 1979 period when monetary policy was excessively stimulative. By comparing current values of the indicators with those in columns 2 and 3 we can determine how stimulative monetary policy has become relative to earlier recoveries and relative to the period of excessive stimulus.

Real interest rates now are higher than during comparable stages of earlier recoveries (column 2) and the period of excessive monetary stimulus (column 3). This would suggest that policy is nowhere near as stimulative as it was during the early stages of the last three recoveries or in 1976 to 1979 when policy was excessively stimulative.

TABLE 2

NONMONETARY INDICATORS OF MONETARY POLICY

Indicator	Latest Observation	Ave. Of Trough & First Recovery Quarter: Last Three Recessions	Stimulative Policy: 1976-1977
Real Commercial Paper Rate (%)	3.4	- .3	.6
Private Borrowing (Divided by GNP)	9.0[e]	9.3	13.3
Commodities Price Growth	6.7[a]	- 8.4	10.0
Foreign Exchange Value of the Dollar	117.9	100.9	97.4

[e]Estimate
[a]Last six weeks average level over previous six weeks, annual rate.

The ratio of private borrowing (i.e., by households, non-financial corporations and state and local governments) to GNP has been a reliable indicator of monetary policy, generally being high when policy has been easy and the economy has been growing rapidly, and low when the opposite was true. In the third quarter of 1982 the ratio was 8.3%. Since then it probably has moved up, partly reflecting an increase in mortgage and consumer installment borrowing.

The current estimate of the borrowing ratio, 9.0%, is close to its average for similar stages of previous economic recoveries. But it is well below its average for 1976 to 1979 when policy was too stimulative. The credit markets thus are not yet signaling excessive stimulus in monetary policy. This is hardly surprising, given the current relatively high level of real interest rates.

The last two indicators try to capture the effect of U.S. monetary policy on the external sector of the U.S. economy -- net exports, or exports minus imports. The first, commodities price growth, represents a measure of world demand for goods, and therefore for U.S. exports. It is influenced by U.S. monetary policy. When U. S. policy is tight, world demand weakens and commodities prices grow more slowly or decline. The demand for U.S. exports weakens in concert with the drop in world demand. The second, the foreign exchange value of the dollar, measures more directly the influence of U.S. policy on net exports.

Market sensitive commodities prices have moved up over the last half dozen weeks. This is in contrast to their behavior during the three earlier recoveries when they continued to decline. The increase in commodities prices, following a 35% decline over the previous two years, is less robust than during the 1976 to 1979 period when such prices grew at a 10% annual rate. Nevertheless, the recent performance of commodities prices seems to suggest that the easing of U.S. monetary

policy is beginning to be felt around the world. All things equal, this should help to stimulate U.S. exports.

Despite its decline over the last three months, the dollar remains high compared to its level during the early stages of the recoveries from the 1970, 1974 and 1980 recessions and compared to its average level from 1976 to 1979.[3] The strong dollar thus will act as a brake on the U.S. recovery.

The four nonmonetary indicators present a mixed picture of the degree of stimulus in U.S. monetary policy. On the one hand, the rise in commodities prices implies policy has moved toward ease. But, on the other, the continuing low level of private sector borrowing and the relatively high level of real interest rates and the high value of the dollar suggest monetary policy has not become excessively stimulative. The stronger, but apparently still moderate, pace of GNP growth in the current quarter supports this judgement.

The absence of excessive stimulus in U.S. monetary policy indicates that interest rates are unlikely to rise much if at all in the next few months. Moreover, a further decline in short-term interest rates would not appear to be inappropriate in the months ahead.

III Concluding Comments: Whither Rates?

Although a further policy easing might be justified, given the continued slow pace of private borrowing and the high levels of real

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[3]Of course the value of the dollar in 1983 is not strictly comparable to that of earlier periods because U.S. inflation has been lower on average than that of the rest of the developed world during the last decade. The dollar, therefore, should be higher on average against the currencies of other developed countries. However, even after adjusting for this inflation differential, the dollar still is very strong.

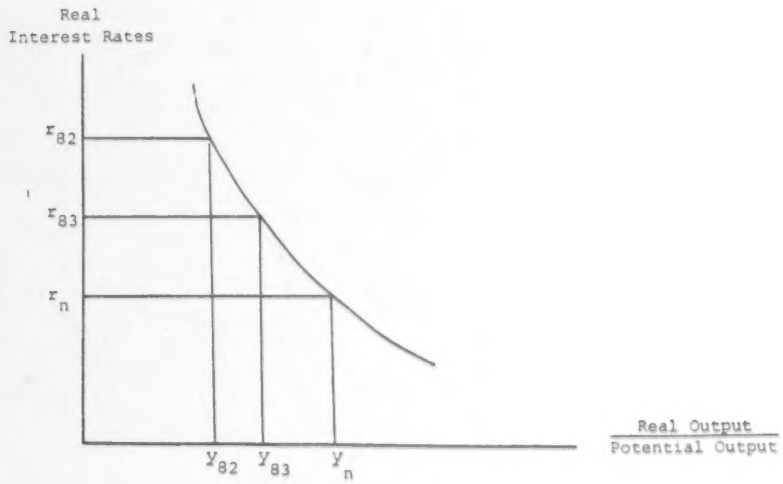
interest rates and the foreign exchange value of the dollar, decisions to lower short-term interest rates must take account of an asymmetry in the attitude of the public toward rate movements when unemployment is high. It is always easy to move rates down, but difficult to move them back up after even a strong recovery has begun.

An overzealous easing of interest rates runs the risk of "trapping" the Fed with rates too low in the event a surprisingly strong recovery should suddenly emerge. Even a strong recovery, it must be remembered, would leave the level of unemployment very high in 1983 and, as a consequence, would not relieve pressures on the Fed to hold rates down. Indeed, as long as a surprisingly strong recovery cannot be ruled out, political constraints may effectively prevent the Fed from lowering rates to desired levels before the economic recovery is assured.

There is a second, strictly economic, reason for not rushing to lower interest rates. Although real rates still are high by historical standards, they are much lower than they were on average last year. The significant decline in interest rates over the last few months probably is more important in determining the change in economic activity than is the still high level of rates (see Stephen Roach, "The 1983 Recovery: Its Evolution and Durability", Morgan Stanley Economic Perspectives, February 8, 1983). The drop in rates to current levels may well be sufficient to assure a moderate rise in economic activity in 1983.

Formally the effect of a decline in interest rates on real output can be see in Figure 2. The downward sloping line indicates that the higher the level of real interest rates, the lower will be the level of real output, relative to its potential. Virtually everyone would accept this sensible relationship between the level of real interest rates and the level of output. But interestingly the relationship implies that lowering real interest rates from a very high level to a lower but still high level raises the level of output -- i.e. it produces positive growth even though the level of real interest rates still is high. This implies that rates of change in output ought to

Figure 2



be associated with rates of change in interest rates, not with levels.

The analytics implicit in Figure 2 can be applied to the outlook for economic activity in 1983, given the current level of real interest rates. Let "r_n" be the "normal" level of real rates at the end of the first year of a recovery. The drop in rates from "r_{82}" to "r_{83}" should induce a positive movement in real output, relative to potential, from "y_{82}" to "y_{83}" even though "r_{83}" is well above the normal level of real rates during a recovery. But, it is interesting to note, the level of output achieved in 1983, "y_{83}" still is well below the "normal" level "y_n" for an economic recovery. This lower level of output in 1983 is the result of real interest rates remaining above normal.

The situation depicted in Figure 2 in fact is perfectly consistent with Morgan Stanley's 1983 outlook for positive growth in real output, but to a level well below normal for the first year of an economic recovery. For example, capacity utilization now is about 68%, well below normal for a business cycle trough. If real GNP should grow by 4 1/2% (fourth quarter to fourth quarter), as we are forecasting, capacity utilization will rise only to about 72% by the end of 1983. This would be well below the utilization rate normally reached after the first year of a recovery. This lower level of economic activity at the end of 1983, and not zero or negative growth for the year, is the price that will be paid for holding real interest rates above their norms during 1983.

The CHAIRMAN. Thank you, Mr. Paulus.
Mr. Zecher.

STATEMENT OF J. RICHARD ZECHER, CHIEF ECONOMIST, CHASE MANHATTAN BANK, NEW YORK

Mr. ZECHER. Mr. Chairman, in my written testimony which was written before Wednesday, I laid out some options that I thought the Fed faced this year in terms of conduct of monetary policy. Since writing it, I have had the opportunity to study Chairman Volcker's testimony on Wednesday—and I must say in agreement with my friend Andy Brimmer that I'm in almost total agreement with the statement of the policy goals for 1983 stated in that testimony. I think that if that policy is followed in 1983 with the degree of agility that will be required within the parameters set out in there that we have in prospect a strong sustainable noninflationary recovery in 1983 and beyond with the prospect also of falling interest rates over that period.

However, I would point out that carrying out the policy has been the biggest problem that we have faced with monetary policy in these past 10 or 15 years. It's not that the statement of policy has been inappropriate; it's been in the carrying out of the policies. So I think we are not out of the woods yet, but I'm really delighted to support Chairman Volcker's statement on Wednesday.

What I'd like to do is take my very brief time here to highlight just a few points from my written testimony and then turn to a few issues in Chairman Volcker's testimony with which I'm in very complete agreement and also one with which I have some disagreement.

Let me first take just a minute to put monetary policy in some historical perspective. I think it's always useful to look where we have been when we are trying to figure out where we should go.

[Complete statement follows:]

STATEMENT OF J. RICHARD ZECHER, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, CHASE MANHATTAN BANK

Mr. Chairman and members of the Committee, I am J. Richard Zecher, Senior Vice President and Chief Economist of The Chase Manhattan Bank. I am pleased to be here to testify on the extremely important matter of the conduct of monetary policy. While my remarks range over a number of issues related to monetary policy, my main focus is on our recent monetary experience and the choices that we now face.

Monetary policy has gone through three distinct regimes since World War II. The first began shortly after the war and had, as a centerpiece, the fixing of the dollar in terms of gold and the fixing of many other currencies in terms of the dollar. This period, from the late 1940s to the late 1960s, was characterized by relatively low inflation and interest rates and by a relatively rapid expansion in economic activity. The second monetary regime was marked by the severance of the dollar from gold in 1973, and by the two oil-price shocks of the middle and late 1970s. This period, from the late 1960s to 1979, experienced considerably higher average levels of money growth, inflation, and interest rates than were common during the earlier regime. By 1979 the developing trends for money growth, inflation, and interest rates—and the associated decline in the international value of the dollar—forced a change to a third regime.

The third monetary regime extended roughly from October 1979 to about midyear 1982. A commitment to reduce growth rates in the monetary aggregates, and to reverse the accelerating inflation of the 1970s, was made in 1979 and carried out in large measure during the period extending to last summer. However, the implementation of the policy was far from smooth, intensifying the volatility in interest rates

and the extended period of slack in the economy that was expected to accompany disinflation.

For a variety of reasons—discussed in my statement—money growth since last summer has been very rapid. Given the events of this period, the Fed was faced, with two choices: (a) accommodate this rapid expansion of monetary aggregates by generating the required growth in the monetary base or (b) apply the monetary brakes again, slowing growth in the aggregates but in the process causing another interest-rate cycle. The Fed chose in this case to abandon its aggregates targeting, thus ending the third monetary regime since the War.

The question now is what policy regime will replace the old one. Will monetary policy drift back toward the interest-rate targeting that led to the crises of the late 1970s? Will it return to a modified aggregates policy that eliminates some of the worst implementation problems of the 1979–82 period, but retains the critical long-term commitment to low inflation through low money-growth rates? Or will it simply drift?

DISINFLATION

In October 1979 the Federal Reserve initiated a monetary policy designed to reduce the rate of inflation in the United States. The policy was supposedly a "monetarist" strategy, i.e., a policy designed to set targets for long-term money growth and to adhere to those targets. The cost of achieving these targets was expected to be wider interest-rate fluctuations. The idea was that the Fed could pursue an aggregates targeting policy, allow for wider fluctuations in short-term interest rates, and curb the inflation rate—providing eventually lower interest rates with a stable growth path for nominal income.

The policy was stated to be monetarist, but its implementation did not please the monetarists. All of the institutional mechanisms of money control that existed before the implementation of the "monetarist" policy continued to function. The methods used to target the aggregates were those developed under the interest-rate targeting. One has to conclude from this experience that aggregates targeting during 1979–82—given those institutional constraints—did not achieve its goal of minimizing the fluctuations of money growth and did not achieve its goal of minimizing the fluctuations in nominal income. But it did achieve its goal of lowering the rate of inflation.

An important corollary of U.S. disinflation, particularly useful for understanding the global recession of 1980–82, was that other major OECD countries also have sharply cut their inflation rates since 1980. While U.S. inflation dropped from 13.5 percent in 1980 to a rate of 3.9 percent in 1982, inflation in the United Kingdom fell from 16 percent to 5.5 percent, and Japan's from 8 percent to around 2.5 percent.

The markets did not believe until quite recently that these disinflationary policies would be successful; even the central bankers initiating the policies around the world did not expect them to be quite as successful as they were. In part because of that gap between belief and reality, interest rates rose sharply while inflation expectations did not come down as rapidly as they otherwise might have. Long-term interest rates consequently were too high to help soften the impact of the rise in short-term rates. Uncertainty about future inflation increased, and high real interest rates contributed to the lower global output experienced during the disinflation.

The October 1979 experiment was a disinflationary policy. The abandonment of it in late 1982 may mean an end to the process of disinflation. Given the institutional arrangements under which the Federal Reserve operates, the rapid decline in interest rates experienced last summer guaranteed that there would be a rapid rise in money growth that would eventually pierce the upper target. A major question was whether the authorities would respond to above-target money growth by tightening monetary policy. Recent experience indicates that the answer, so far, is no. But how long they will be able to ignore the rapid rate of money growth, should it continue, remains an unanswered question.

The view that money growth may be very moderate in the coming months is, fortunately, more than just wishful thinking. Given the Fed's operating procedures, a period of very slow money growth is in fact highly likely. Three transient influences explain most of the rapid growth in money since last summer. The first—the rapid decline in interest rates and the Fed's response—ran its course by December. The other two, involving the introduction of money-market and super-N.O.W. accounts, have caused distortions in the monetary aggregates that we believe will be largely dissipated by the end of February. Of course, if this analysis proves wrong and the aggregates continue to grow rapidly, inflation will once again return to the center stage of our concerns.

ALTERNATIVE COURSES

Having abandoned monetary targets in the last half of 1982, the Federal Reserve is now perceived by many to be adrift. The problem with abandoning monetary targets is that there now is no guide for evaluating long-run Fed policy. Under aggregates targeting one knew something about the long run, even if there remained tremendous uncertainties about the short run. Today we have the opposite problem. We have short-run stability in financial markets relative to recent experience, but we are paying for it with greatly increased uncertainty about the long run.

The issue, then, is whether the Fed has a better alternative than the aggregates policy that it pursued from October 1979 to October 1982. If the only other choice is merely a return to interest-rate targeting as it was practiced in the 1970s, then there is no viable option at all.

The recent behavior of the monetary aggregates is consistent with several possible courses the Fed may have chosen to pursue. The market is now attempting to judge which strategy will eventually be followed by the authorities. At least three interpretations are feasible: aggregates targeting, interest-rate targeting, or aimless drift. First, money growth and the behavior of both short- and long-term interest rates have been consistent with a monetary-aggregates policy predicated upon the belief that inflation is under long-run control. In this view, inflation expectations have fallen sufficiently to allow the level of the money stock to increase once and for all, for the temporary reasons detailed above. After a period of adjustment, a new set of aggregates would be announced and a continuation of the earlier aggregates policy could be reinstituted. Second, the recent rise in the stock of money—including the monetary base—is consistent with an interest-rate targeting policy that may or may not prove to be inflationary. And third, the recent experience is perfectly consistent with no policy at all—that is, with a monetary authority adrift, searching for direction after abandoning an approach that was proving to be too costly.

Beginning with the last interpretation first, there is a danger that this view of a floundering Federal Reserve may become the accepted wisdom of the market. Such a course for the Fed—one dictated by fears of Congress, of the White House, or of other political constituencies—is fraught with uncertaintly. It would open the economy to a multitude of problems. The most severe problem is similar to that of the early 1930s; indecision during a time of perceived or real crisis. With the authorities adrift, it is possible that the investing and saving public would have to deal with uncertainties large enough to abort the incipient recovery and trigger another recession.

If the second interpretation—that the Fed has returned to interest-rate targeting—proves to be correct, this course could lead to any of three possible paths. Depending on how it is handled, it could prove to be inflationary, it could prove to be deflationary, or it could prove to be neither. The trouble is that there is little basis for forecasting the ultimate effects of such a strategy. Given the experience of the 1970s, one might expect this type of policy to be inflationary. But this conclusion may prove to be wrong, just as the expectation (embodied in long-term interest rates) that policy was not going to be inflationary during the 1960s was proved wrong. In either case, the policy does not lend itself to predictable results beyond the immediate period.

The first course—a return to some type of aggregates targeting—appears to be the only logical long-run strategy for the Fed to pursue. The system needs to be firmly anchored by a credible Federal Reserve anti-inflationary policy. The markets must have information about the long-run direction of policy in order to make long-term investment decisions. This does not mean a return to the experiences of the October 1979–October 1982 period, and it does mean an assurance to the public that an aggregates-targeting policy is being adhered to in the long run.

REAL ECONOMIC ACTIVITY

Because of the fragile state of the incipient economic recovery, the choice of a proper course for monetary policy is now of the utmost importance. In 1979 there were two major shocks to the world economy: a shift to disinflationary policies and a dramatic increase in oil prices. Both shocks did much to contribute to the past three years of stagnation in the U.S. and global economies. The oil-price increase has had a more-permanent effect on U.S. economic activity, lowering our long-run potential real growth path by reducing the economic efficiency of our capital stock and our workers.

Nevertheless, there are growing signs that the economy at last is beginning to pull out of the recessionary period of the past three years. In the industrial sector, the stage is set for a fairly sharp upturn in production. New factory orders have

been on an upward trend for the past few months. At the same time, inventories have been cut at a record pace. Thus, manufacturers are likely to meet any increase in demand by quickly increasing production to replenish stocks for future sales. The auto industry is a prime example. Sales of domestic makes in the last three months are running 10 percent ahead of the previous three-month period, and production is up more than 20 percent from its low in November. Construction has also shown dramatic gains. Housing starts are about 20 percent higher than a few months ago, and nearly 50 percent above their year-ago level.

To be sure, not all the news is so cheerful. Other than cars, retail sales have been somewhat lackluster. And business spending for new plant and equipment continues to fall. On the other hand, an unquestionably bright spot is the progress made against inflation. January's record 1.0 percent decline in producer prices brought the year-over-year gain down to just 2.1 percent, while consumer prices posted only a 3.9 percent increase during 1982. For both measures, these rises were the smallest in a decade. Taken as a whole, our reading of the current indicators of economic activity suggests that this quarter should show positive economic growth, and that the prospects are good for growth in real GNP of 4 percent or more between the fourth quarter of 1982 and the fourth quarter of 1983.

As with all economic forecasts, events may unfold quite differently than assumed. For example, there is one big positive risk to this forecast. We may now be seeing that the oil-price shock, which we argued caused the United States to move to a lower output path, was a temporary phenomenon. We may be learning that the large and rapid responses of industry and consumers to the relative-price shifts have been sufficient to ensure that relative oil prices in the United States during the 1980s will be similar to those of the pre-1979 shock. If this is the case, then we may be underestimating the U.S. potential-output path. The dynamic readjustment to a higher potential output would mean that 1983 and 1984 taken together could be a period of very strong real growth, compared with past recoveries from recessions. Such an event is not totally unlikely.

On the other hand, the negative risks to our forecast are large as well. In fact, those combined risks are greater than any risk of our underestimating the level of potential output. First, as noted earlier, there is a great deal of uncertainty about the course of monetary policy. Second, there is at least as great a level of uncertainty about the course of federal spending, taxing, and deficits in the United States. Third, there is heightened uncertainty about the commitment of major trading nations to free trade. Fourth, there is uncertainty over the ability of the international financial system to withstand additional shocks of the type experienced in 1982. Several of these risks have global implications.

First, a major risk is that a reignition of the world's economic engine could result in a coordinated acceleration of inflation, much as the policies of 1980–82 resulted in a coordinated disinflation. Just as the public was fooled about how quickly inflation came down, the public could likewise be fooled about how fast inflation starts up again. This would lead eventually to a rise in interest rates—both nominal and real—from their already high levels, and depress investment and other interest-sensitive expenditures.

Second, events of the past four years, particularly disinflation and the oil-price shock, have been as debilitating to governments—in their abilities to manage spending, taxing, and deficits effectively—as they have been to the private side of the global economy. Government deficits are everywhere large, and present serious problems to virtually every national government. Public spending and revenue programs have deviated widely from budget plans both domestically and abroad, in large measure because of unexpected disinflation and the extended worldwide recession. The degree of success in regaining control over government spending and borrowing requirements will become increasingly important as the private economy recovers.

A third threat to recovery concerns the cries for protectionism, which may abort the recovery of world trade that is so critical to a healthy recovery in the United States, as well as in the other OECD countries and the developing world. While the threat of destructively competitive protectionist moves and countermoves has diminished somewhat in recent months, it continues to pose a serious problem for a normal economic recovery.

A fourth downside risk is related to the possibility of an international liquidity crisis. While any analysis of the prospects for economic recovery must take this possibility into account, much progress has been made in understanding the dimensions of the risk and the steps that must be taken by each of the major participants in order to contain this risk. As outlined by Chase Manhattan Bank Vice-Chairman William B. Ogden before two Congressional committees recently, there is every

reason to believe that the international liquidity problems that became highly visible in 1982 can be contained.

SUMMARY

Monetary policy is at a crossroads. Policies of the past three or four years have failed to bring stability and economic growth, but they have succeeded in breaking the depressing cycles of ever-accelerating inflation of the 1970s. The economic costs of breaking the inflationary cycle have now been paid in terms of high unemployment and lost output. By reaffirming the principle of aggregates targeting as a long-run strategy, the Federal Reserve can maintain its hard-won credibility and preserve the gains that have been made at so high a sacrifice.

Mr. ZECHER. I'd like to point out three things with which I am in total agreement and support in his statement.

The first concerns his economic forecast for the assumptions under which monetary policy is now being planned for 1983.

Certainly, I agree that the recent evidence suggests that the recovery is underway and that we should look for real GNP growth in 1983 in the fourth quarter over fourth quarter base of at least 4 percent. I also agree with his inflation outlook which is lower than many in the 4-percent range. I think those are the best planning assumptions one can use right now.

MONETARY POLICY MUST WALK TIGHT LINE

Second, I also agree with him in terms of the dangers he sees in conducting monetary policy in 1983. First of all, the economy is well on a recovery path, though extremely fragile. Monetary policy perhaps more than in any other time in recent history must walk a very tight line in 1983. He points out and I certainly agree that there are large short-term costs—and short-term is perhaps a flippant way to put this because it has to do with recovery—short-run costs of either going too fast or too slow with money growth in 1983. Too fast a growth will lead to a runup of long-term rates and I would expect also in short-term rates in 1983 which could abort recovery that we now see developing. Too slow a growth, on the other hand, would not supply liquidity to the economy to support nominal income growth in the 8- to 9-percent range that he feels is necessary.

In the longer run, of course, if this monetary growth is too fast and inflation expectations are rekindled, and in fact materialize in 1984 and beyond, then the horrible price that we have paid since 1980 in terms of lost production, in terms of unemployment, will have gone again for nought.

Third, the policy uncertainty that he sees and focuses on in his testimony can be summarized essentially in one question. What will velocity do in 1983? No one in this room I'm sure knows the answer to that question. If he did, they certainly should share it with everybody else.

Given the uncertainties about velocity and in particular whether velocity will behave in this recovery as it has traditionally in the past, that is increasing above its long-term current rate, remains a very open question because of all the other things that are the subject of this hearing and you have been discussing and what effect they will have on velocity in 1983.

I think given these uncertainties that the ranges that the Chairman set out on Wednesday are entirely appropriate but again I would say the important thing will be how they are carried out over this year and for that reason I was particularly glad to see that the Fed will be reviewing on an accelerated schedule the development of monetary policy this year from their normal 6-month review.

The one issue—and this is my last point—on which I would raise some disagreement with the Chairman concerns introduction of a new target or new potential target for monetary policy guidance and that was the broader credit aggregate. I have a number of problems with this particular variable. Some are technical problems and some are problems in theory. I'll just mention a couple.

Technically, the numbers that Chairman Volcker pointed out on Wednesday to support the measurement of this aggregate are not now very good and they are not now very timely. That's a fairly minor objection compared to the other.

The other is a theoretical objection which takes note of the fact that the Fed doesn't really control this aggregate even though it may be closely related to total nominal GNP growth over time.

In general, my views on this aggregate are summarized by an old Chinese proverb which says the man that has one watch always knows what time it is; the man who has two is always in doubt. That's the conclusion of my statement.

The CHAIRMAN. Thank you very much.

Mr. Zecher, what's your opinion of postponing the contemporaneous reserve accounting until 1984?

Mr. ZECHER. Well, I think the operating procedures that I referred to in several places in my oral and written statement focus on this issue in particular. I think this is a desirable change even though it will impose additional costs on my institution as well as banks generally. It is after all the way that we did run monetary policy from roughly 1917 until 1968 when lagged reserve accounting was introduced. It would provide some significant, in my view, increase in the ability of the Fed to control short-term fluctuations in the aggregate and for that reason I think it's desirable and should be implemented as soon as possible.

The CHAIRMAN. Then you would disagree with postponing it until 1984?

Mr. ZECHER. Yes, I would.

The CHAIRMAN. I've been jawboning for years to get them to do it and was pleased when they finally made the decision and now disappointed that they are not going ahead with it as soon as they originally announced.

Mr. ZECHER. Yes, sir. I totally agree with you and I wish they had stuck with the original schedule.

MONEY GROWTH OPINIONS

The CHAIRMAN. Mr. Paulus, Mr. Brimmer believes that money growth will continue to be rapid in the months ahead and Mr. Zecher expects moderation. Would you explain the difference between the two positions for me?

Mr. ZECHER. Well, one will be right and one will be wrong.

The CHAIRMAN. I figured if I asked either one of them they would just restate their position, so I'll take the middle ground.

Mr. PAULUS. Well, by money, I think you must be talking about M_1.

The CHAIRMAN. Yes.

Mr. PAULUS. I don't think it's useful to talk about M_2. A major determinant of M_1 growth is the rate of growth in nominal spending which has been moving up. Nominal GNP grew by 3 percent last year. We think it will be growing in the 8- to 9-percent area in the first half of this year, maybe a little more rapidly in the second half. Most of the effect of declining interest rates, which does tend to push money growth up, is behind us, as Mr. Zecher pointed out, and I agree with that. The one-time shifts of funds, which quite frankly perplex me—I don't understand why M_1 is attracting so many nontransactions funds into things like Super NOW's—but I think that shift is largely behind us.

I'm really in between these two. I think we will have moderate growth in the 7-percent area for the first half of this year.

Mr. BRIMMER. Mr. Chairman, may I extend that?

The CHAIRMAN. Certainly.

Mr. BRIMMER. I believe I stressed that—despite the enunciation of the new targets—I thought that, over the year as a whole, the Federal Reserve would find it difficult to live within those targets. Take, for example, the targets for M_2. Although John Paulus thinks it's unwise for the Fed to follow them—I believe they may find it difficult to live within them. I had in mind a chart from the Federal Reserve report to Congress which was with Chairman Volcker's testimony. I was looking particularly at M_1. I believe that there is no way whatsoever to get that enormous trajectory back within the targets over the near term. For that reason, I think that, if the Fed were to try to do that, it would be a mistake.

But I would not expect to see the growth rates in M_1 continue. In other words, I would not extrapolate that line so sharply upward [indicating]. So it is quite interesting that you asked the question.

The CHAIRMAN. Mr. Zecher, your defense?

Mr. ZECHER. Well, I'm not going to defend, sir, but I would like to point out that my statement says from the end of February forward, and I'm not suggesting that the bulge that we have seen which I think is for the three temporary reasons that I mentioned—the two new accounts and the drop in interest rates last summer—should be or will be reversed. I'm talking about the period going forward from February and I believe this is very consistent with Chairman Volcker's testimony because he is going to base his M_2 targets forward from the first quarter which I think is the very reasonable thing to do under the circumstances.

Mr. BRIMMER. February–March.

Mr. PAULUS. That's right.

COMPETITIVE INEQUITIES WITHIN FINANCIAL SERVICES

The CHAIRMAN. Mr. Zecher, a great deal has been said the past few weeks and particularly this week about competitive inequities that may result from the institutional restructuring and new accounts that are occurring within the financial services industry.

What do you see as the potential consequences of this restructuring on the credit markets?

Mr. ZECHER. Well, I think it's very healthy. I think the general view of bankers, which I will try to represent here although it's very difficult to do, is that after many decades of very comfortable regulation they are beginning to understand both the cost and benefits of competition. I think basically, as I talk to bankers, they are ready to compete in this market even though they are not going to always win. But learning to compete after a very long period of being protected from competition is causing a little agony certainly.

The CHAIRMAN. What about the effect on the Fed's conduct of monetary policy?

Mr. ZECHER. I think obviously it has caused this period of very difficult interpretation of monetary policy. I personally feel that's a very small price to pay for the longer term benefits to the consumer of having a much more competitive financial system. I'm all for it and my institution is all for it.

The CHAIRMAN. Mr. Brimmer, the Federal Reserve intends and certainly in the immediate future to focus much more on M_2 than M_1, but with the newly authorized accounts that are going to tend to concentrate savings and precautionary balances in M_2, wouldn't really making M_1 a more exclusive transaction account—wouldn't it be better to concentrate more on M_1 than M_2?

Mr. BRIMMER. No, Mr. Chairman, it would not be, if you mean by "better," to concentrate on M_1 as the most critical guide in the conduct and implementation of monetary policy. It would not be better. Some of the funds in M_2 are related to transactions. It is impossible to distinguish so sharply between the balances in M_1—and call those purely transactions—and the funds in M_2 (some of which are quite comparable). The presumption is that we should have as a guide a monetary measure which is related fairly closely to nominal GNP. The record will show that the broader the aggregate the more closely related to nominal GNP it is. For that reason, unlike Dick, I would not criticize the Federal Reserve so severely for having introduced a measure of total nonfinancial debt. The record shows that changes in that variable are associated very closely with changes in nominal GNP. M_2 is in between. M_2 is related somewhat more closely to nominal GNP that is M_1. Since I do not subscribe to the belief that it is necessary to relate M_1 only to nominal GNP, I would not subscribe to the view you just enunciated.

The CHAIRMAN. Would both of you gentlemen respond to the same question, please?

M_2 IS A BIG MISTAKE

Mr. PAULUS. I think M_2 is a big mistake. I think moving to a credit aggregate is a good idea. I wish they'd move to private nonfinancial private sector borrowing, borrowing by households. State, and local governments which I put in the private sector because they have a budget constraint, and nonfinancial corporations. Such borrowing is a much better indicator of monetary policy than is total credit.

But during periods like those we've experienced in the last 2 years, when the aggregates really have broken down, it would have been useful, especially last spring when private sector borrowing was so depressed, to have had an additional reading on monetary policy outside the aggregates which at the time were looking relatively strong. I think we would have had a truer reading of what monetary policy was doing to the economy had we had a credit aggregate. On M_2 I would like to point out that the Fed's research staff has some rather interesting work showing that two of the major determinants of M_2 growth are the savings rate and the unemployment rate. M_2 is positively related to the savings rate and the unemployment rate: The savings rate because when it goes up there's a bigger pool of savings, and the unemployment rate apparently because people get concerned when unemployment goes up and they put a disproportionate share of their savings into M_2 type liquid assets. But what happens when monetary policy tightens? The unemployment rate goes up and the savings rate goes up, so that M_2 growth goes up. Possibly the reverse will happen when the Fed eases off.

It doesn't make any sense to me to be targeting on an aggregate that has such perverse properties. I think M_1, despite the problems with it, is clearly the best aggregate the Fed has now and over time, aside from some temporary periods, it has been the most reliable indicator of monetary policy on the economy.

The CHAIRMAN. Mr. Zecher.

Mr. ZECHER. Well, let me start by asking you a question. What are we really trying to accomplish with looking at aggregates? I would argue that the most important thing—you were talking about the real world earlier today. There's all kinds of real worlds. There's the bond trading real world which means if it happened more than 2 seconds ago it doesn't mean anything or if it's going to happen 2 seconds from now it doesn't mean anything. There are lots of realities and I think the reality that's most important for monetary policy—and it can only be stated in a very vague way, I agree—is that we want a stable, noninflationary environment where contracts can be made with some reliance for periods longer than 3 months.

Now if you accept that as the overall goal of monetary policy, then I don't think it's going to make very much difference which of these aggregates you look at over that long period of time. Where it would make a difference is in the implementation of the policy and Andy makes a very good point, that some of these aggregates are more closely related statistically in the short run to nominal spending than others.

In effect, I think he's absolutely right at least until the 1980 period that the broader the aggregate the more closely in the statistical quarter by quarter sense it is related.

There is another issue and that is what can the Fed do to control it? If we can rank these various aggregates we talk about starting let's say with the monetary base, which is the reserves and currency in circulation, the Fed has very precise control over that, but it has a weaker statistical relationship to income.

What I'm saying is in the implementation policy there is a tradeoff between two statistical correlations. One is between what the

Fed actually does and what happens to one or another of those aggregates, and the second is between what happens to those aggregates and what happens to nominal income.

Finally, I would argue—and this is one of the points I made with respect to this credit aggregate—is that the Fed in a world where there are remaining private banks who make credit decisions and in a world with open international trade, the Fed has very little short term control over that aggregate.

Mr. BRIMMER. Just for the record, I think we ought to stress that, while the Federal Reserve indicated it would monitor the behavior of the debt aggregate, it is not on the same footing as are the targets for the monetary aggregate. So they will watch it, but it's my impression they do not intend to gear policy directly to that.

Mr. PAULUS. If I could add, it's an indicator, not a target. You don't have to be able to control an indicator. An indicator tells you something about what your policy is doing to the economy. It would be useful to have indicators even if you can't control them.

The CHAIRMAN. Gentlemen, I have no additional questions. Others may be submitted to you for your response in writing. Do any of you have anything to add before we close the hearing today?

Mr. ZECHER. I have none, Mr. Chairman.

Mr. BRIMMER. No.

Mr. PAULUS. None.

The CHAIRMAN. Gentlemen, thank you for your patience and your testimony. We appreciate very much your willingness to come before the committee.

The committee is adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1983

TUESDAY, FEBRUARY 22, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Mattingly, and Hecht.

The CHAIRMAN. The committee will come to order.

This morning is the third day of hearings on the conduct of monetary policy. I believe the first 2 days were excellent and we had good testimony and good question and answer periods, and I'm sure that today will be no different.

We are happy to have the Honorable Beryl Sprinkel, Under Secretary for Monetary Affairs, Department of Treasury, to present to the committee the Treasury's position on monetary policy.

Mr. Sprinkel, we are happy to have you before the committee this morning.

STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SPRINKEL. Thank you, Senator Garn. It's a pleasure to be here.

Chairman Garn, distinguished members of the committee, it is my pleasure to be here today to present Treasury's views on current monetary policy, and to discuss your concerns and questions on the subject.

MONETARY POLICY IN 1983

The task for monetary policy in 1983 appears to be clear. Chairman Volcker stated it well in his testimony before this committee last week when he said, "Our objective is easy to state in principle—to maintain progress toward price stability while providing the money and liquidity necessary to support economic growth." From my discussions with other administration officials, Federal Reserve officials, businessmen and economists, and from my reading of the financial press, there appears to be widespread, general consensus that this is the appropriate goal for monetary policy in 1983 and the targets set by the Federal Reserve are broadly consistent with that goal. But general agreement does not, in and of itself, produce the desired results. If it did, we presumably would

not have had a decade and a half of rising inflation and interest rates and the resultant economic stagnation; certainly no one sought or desired those results.

The subtleties and complexities of monetary control are such that achieving a particular desired policy path—regardless of a consensus that it is appropriate—is never a certainty. Our knowledge of the exact magnitude and timing of the impact of monetary actions is imperfect; the lag in their impact on the economy is variable. For either—or a combination of both—of these reasons, there is always a risk that actual monetary policy will not match intentions or goals.

Without great care in the implementation of monetary policy in the coming months, there is a risk that the Federal Reserve could err in one direction and be too highly restrictive, or in the other direction, and be overly expansionary. The danger to the economy is that the economic recovery could be aborted, or the gains we have made in reducing inflation could be lost, or both. It is these risks and dangers that I would like to discuss with you today.

First, I believe it would be instructive briefly to review where we are, and how we arrived where we are, with respect to monetary policy.

THE GENERAL SITUATION

A deceleration in the trend rate of money growth is necessary to reduce inflation; it is for this reason that the administration originally recommended that money growth be gradually and steadily slowed. When I met with this committee last July, I emphasized the importance of the gradual and steady aspect of that recommendation. Few believed that the slowing of money growth necessary to control inflation could be achieved without some associated restraint on the growth of economic activity; but we did believe that a gradual and steady deceleration would minimize the constraint on the economy, and that that constraint might be offset in the long run by the incentive effects of the tax cut. However it is difficult to characterize the slowdown in money growth that actually occurred as either gradual or steady. As a consequence, while impressive progress has been made on inflation, the restriction of economic activity associated with that progress was magnified.

In 1981, money growth was abruptly and significantly reduced relative to its previous growth path; after 4 years of money growth that averaged 7.8 percent, M_1 growth in 1981 was 5 percent. For calendar 1981, M_1 growth was therefore below the target growth range set by the Federal Reserve. After a short period of rapid growth in late 1981 and early January 1982, the restraint on money growth continued until midsummer of 1982. By mid-1982, the path of M_1 was well below the deceleration path that had been recommended by the administration. This severe and prolonged monetary restriction was an important factor contributing to the onset, severity, and duration of the recession.

By contrast, since July of 1982 money has grown at a very rapid pace; during the last quarter of the year, M_1 grew at an annual compound rate of nearly 14 percent. As a consequence, M_1 growth in 1982 averaged 8½ percent, well above the 5½ percent path that

was the upper bound of the Federal Reserve's money growth target.

On the positive side, the monetary surge in the last half of 1982 can be viewed as an abrupt and belated adjustment for the previous, prolonged undershooting. The rapid pace of money growth in recent months, in fact, brought the fourth-quarter, 1982 average of M_1 up to the level that was implied by the administration's originally recommended path for prudent noninflationary monetary policy. Although we arrived at approximately the same average level for M_1 by the fourth quarter of 1982, the path by which we did so was less than ideal.

An important lesson to be learned from the experience of recent years is that we pay a very high and very real price for monetary instability. The timing of the relationship between money growth and real economic activity is affected by a variety of factors, including the public's expectations about fiscal and monetary policies. Because of the elusiveness of expectations, any exact quantification of the economic impact of erratic money growth could be disputed; however, the direction of the effect seems clear. In short, while monetary policy seems to many to be academic and arcane, the effects of monetary actions are neither. The impact of monetary actions is felt in very practical and real ways—as manifested in inflation, interest rates, real economic growth, and the unemployment statistics.

Looking to the future, the monetary actions taken by the Federal Reserve will, as they have in the past, be critically important to economic performance in 1983–84. Obviously we can all agree that nurturing an economic recovery is our primary concern. But it is also vitally important that that recovery be a healthy and sustainable one, rather than either a recovery that stalls out quickly, or one that consists of an inflationary burst of economic activity that falters as inflationary expectations drive interest rates up and choke off expansion.

The challenge is to pursue policies that will provide the atmosphere needed for a sustainable, noninflationary economic expansion. With the rapid rate of money growth that has occurred in the last 6 months, the risks associated with monetary policy are that either: One, the monetary expansion would be abruptly curtailed, restraining output and employment growth as it did in 1981–82; or two, the Federal Reserve would allow the monetary expansion to continue too long, reigniting inflationary expectations, driving long-term interest rates up and preventing a sustained recovery. Great care in the implementation of monetary actions will be needed if both these pitfalls are to be avoided.

THE DANGER OF BEING OVERLY RESTRICTIVE

It would be ill-advised for the Federal Reserve to attempt to reverse the bulge in money that has occurred in the last few months. Such a monetary contraction would almost certainly stall any meaningful economic recovery, and could, depending on its severity and duration, plunge the economy into a deeper recession.

However, it is clear that money growth cannot continue at the pace of the last quarter without precipitating economic disaster.

The risk, however, is that an attempt to slow money growth may result in too severe, or too prolonged, a monetary squeeze. In the past, periods of rapid money growth have typically been followed by long periods of restriction. A prolonged period of slow money growth would again curtail the growth of employment and output as it did in 1981–82.

The challenge of reinstating noninflationary monetary policy is to bring down the long-run trend of money growth gradually enough that the restriction of economic activity is avoided. Permanent and continued progress toward lower inflation and interest rates requires that we persevere in our efforts to bring the trend of money growth back to a noninflationary pace. But, after 6 months of very rapid money growth, great care must be taken that those efforts do not result in another severe and lengthy restraint of money growth. Economic expansion cannot proceed without the support of adequate liquidity.

THE DANGER OF EXCESSIVELY STIMULATIVE MONETARY POLICY

An economic recovery based on highly stimulative monetary policy is ultimately unsustainable, because the inevitable consequence of excessive money growth is inflation and rising interest rates, both of which are powerful deterrents to the long-run real economic growth we all seek. Rapid money growth does provide a stimulus to nominal GNP growth; a crucial concern, however, is whether that nonminal income growth consists of real economic expansion [growth of real GNP], or of inflation. Rapid money growth may provide a temporary, short-lived stimulus to the economy, but once inflation and inflationary expectations emerge, real growth is choked off by rising interest rates. Once that point is reached, continued stimulative monetary policy is predominantly inflationary.

The key is the reaction of interest rates to the increase in money growth. If the financial markets fail to recognize the implications of rapid money growth, the rise in interest rates might be postponed, and the positive, stimulative effect of monetary expansion could last longer. But the more quickly inflationary expectations, and therefore interest rates, react, the more ineffective monetary expansion will be in providing economic stimulus. As has been illustrated often in recent years, interest rates and money growth can and do move in the same direction when market expectations and uncertainty about inflation are sensitive to the inflationary implications of increases in the money supply.

In this sense, recent developments in the financial markets contain some foreboding signals. Chart 1, accompanying my prepared testimony, illustrates the recent course of a representative short-term and long-term interest rate. While it is widely believed that the decline in interest rates that occurred last summer was the result of a more accommodative Federal Reserve policy, this is not really an accurate portrayal of the timing of events. Money growth began to accelerate in August and, as can be seen in the chart, most of the decline in interest rates had already occurred by August. Some short-term rates are now slightly lower than they were in late August, but the 3-month Treasury bill rate is slightly higher now than it was the last week in August. The decline in

long-term rates continued into the fall, but then leveled off; long rates have risen slightly in the last few months.

Therefore while the rapid growth of bank reserves provided by the Federal Reserve in recent months did push short-term interest rates down to some extent, attempts to continue to do so are likely to be self-defeating. We have already seen a leveling off of short-term rates despite continued rapid reserve and money growth; the last decrease in the discount rate did not elicit similar decreases in short-term market rates. As Chairman Volcker has stated on many occasions, the Federal Reserve has no button to push to cause interest rates to fall.

In terms of its long-run implications, the failure of long-term rates to follow short rates down and the recent upturn in long rates, despite continued rapid growth in reserves and money, is a foreboding signal of the financial markets' expectations. The only logical explanation of this development is that the financial markets are observing current reserve and money growth and making some calculation about expected, future inflation—or at least some calculation of their fear or skepticism about future inflation. Inflationary expectations is the only plausible connection between short-run changes in money growth and long-term interest rates. Thus, while it may be possible for the Federal Reserve to temporarily push down, or hold down, short-term interest rates by injecting more reserves into the banking system, such actions are not likely to generate the desired decreases in long-term rates; under certain market conditions, even the desired declines in short-term rates may not materialize.

A key element in the behavior of long-term rates is inflationary expectations. In the current situation, the uncertainty about the budget situation and about long-run inflation control has heightened the sensitivity of inflationary expectations. The uptick in long-term rates in recent months may be the first signal that, from the viewpoint of the financial markets, the monetary expansion has gone too far.

This is the danger of using excessively expansionary money growth in an attempt to stimulate the economy. There may be limited short-term success, as long as long-run inflationary expectations do not move adversely. But predicting the timing of those expectations with any degree of precision is impossible; helpful, stimulative money growth ultimately turns into excessive money growth that drives inflationarty expectations and interest rates upward and precludes continued, real economic expansion.

The path of long-term interest rates will be a critical factor in determining whether or not the incipient recovery will evolve into a period of sustained real economic growth. In my view, one of the most troublesome developments over the past decade and a half has been the successive upward drift of long-term interest rates. Chart 2 illustrates the upward trend of long rates over the past 25 years and relates it to the rising trend rate of money growth. While there have been many periods when long-term rates fell—notably during or directly after recessions—the low point of each downturn in long-term rates has been higher than the previous one. Each upturn has taken long rates to new highs, and each successive low point has been at a level higher than the preceding

low point. The rising trend of inflation and long-term interest rates has most likely contributed to our long-run problems of lagging investment and productivity growth.

The most important message in chart 2 for the current situation is that we have not yet broken this pattern. While long-term rates are now well below their all-time highs reached in 1981, they have not yet broken below their previous cyclical low, which, from a historical standpoint, was not particularly low. Despite the significant decline in inflation, we have not yet succeeded in breaking the trend of secularly rising long-term interest rates. The implications of this for long-run, real economic growth are not encouraging.

The behavior of long-term rates and their reaction to money growth is the immediate and practical danger of continuing rapid money growth. Attempts by the Federal Reserve to push down, or hold down, short-term interest rates would require continued rapid growth of reserves and money. Particularly as the economy grows more strongly and credit demand increases, upward pressures on short-term rates will emerge; more and more reserve growth would be required to hold down short-term interest rates in the face of these market pressures. Ultimately, the resulting money growth would aggravate inflationary expectations and cause long-term rates to rise, thereby defeating the intended goal of encouraging lower interest rates.

WHERE DO WE GO FROM HERE?

With economic dangers lurking both on the side of too much money growth, and on the side of too much restraint, the safest course is to provide moderate money growth. That is, of course, easier to state than it is to achieve. The chances of achieving that goal, however, would be maximized if the Federal Reserve would move now to restrain the growth of bank reserves in order to slow money growth gradually from the high rates of recent months. Efforts by the Federal Reserve to peg or reduce short-term interest rates are not likely to produce that result.

Actions to return reserve growth to a rate consistent with moderate money growth may cause immediate, but temporary, increases in short-term interest rates. Bank reserves have grown very rapidly for many months, so upward pressure on short-term rates is the price we now may have to pay to restore more moderate growth and to protect long-term rates from the large increases that are inevitable if reserve and money growth is not moderated.

There are many who contend that more rapid money growth now is acceptable because of the weakness of the economy and because it can be reversed later on, once the recovery is more strongly underway. This view presumes that sometime in the future will be the "right time" for bank reserve and money growth to be easily, conveniently and painlessly brought back under control. Furthermore, this analysis makes some heroic assumptions about the precision of monetary control and economic forecasting.

Continuing to allow rapid money growth in order to stimulate economic recovery presumes that the monetary authority can apply the appropriate dose of monetary stimulus for just long enough to provide expansion, but neither too much, nor for too

long, to generate more inflation and inflationary expectations. Given the inaccuracies of economic forecasting and the deficiencies in our knowledge about the timing and impact of monetary actions, it is extremely difficult to determine the moment when helpful stimulus becomes harmful and inflationary. Furthermore, even if that moment could be a accurately determined, such fine-tuning policies presume a precision for monetary control that could, but unfortunately, does not exist. Such monetary fine-tuning sounds logical and reasonable in casual conversation, but it is extremely difficult to achieve; it has not worked reliably in the past and the attempts on average have been very destabilizing.

The money growth target ranges for 1983, announced by Chairman Volcker last week, are consistent with our goal of providing enough money growth to support the expansion, without reigniting inflationary pressures. While the ranges set for M_1 and M_2 for 1983 are higher than their 1982 ranges, these adjustments were made in order to account for the effects of institutional change. Changes in the money supply that are the result of institutional change have no particular economic meaning. It is therefore appropriate to adjust the money growth targets to take account of these changes, as they can best be estimated at this time. The Federal Reserve has stated that the new targets, after adjustment for institutional change, are comparable to the 1982 targets in terms of economic meaning.

With respect to the new targets, Chairman Volcker said in his statement that "* * * the growth of money and credit will need to be reduced to encourage a return to reasonable price stability. The targets set out are consistent with that intent." The administration agrees with that goal and intent. Since money growth exceeded the targets in 1982, average money growth will be lower in 1983 if the new target ranges are achieved; this is consistent with the goal, shared by the administration and the Federal Reserve, of noninflationary money growth over the long run.

CONCLUSION

The sustained, noninflationary economic expansion that we all desire—and that has repeatedly eluded us over the past 15 years—is, I believe, now within our grasp. Whether or not it becomes a reality obviously does not depend exclusively on monetary policy, but the monetary actions taken in coming months and years will be critically important.

On the one hand, another prolonged period of restricted money growth as we had in 1981 and early 1982, would depress economic activity and would likely interrupt, if not prevent, the recovery. On the other hand, attempts to use excessive money growth as an economic stimulus carry a significant risk of backfiring. The key is money growth that is supportive of economic expansion, but not so stimulative that inflationary expectations move adversely. These expectations, which are already sensitized by the projected budget deficits, are the major factors that have held up long-term interest rates even as the actual rate of inflation has declined.

The immediate contribution that monetary policy can make to a sustainable economic expansion is to facilitate continued down-

ward adjustment of price expectations, to allow the entire structure of interest rates to fall. Downward adjustment of long-term price expectations over the course of this year is necessary to assure a meaningful and lasting decrease in the cost of credit, which is a vital element to meaningful economic recovery. Holding short-term interest rates down by continuing to provide more reserves to the banking system, however, is not likely to produce the desired downward pressures on longer term interest rates.

The risk of excessive monetary expansion early in 1983 is not an immediate resurgence of inflation. It is unlikely that excessive money growth would have an appreciable effect on the price indices for more than a year. Instead, the danger comes from the potential impact of expectations about the longer term prospects for inflation.

[Charts accompanying statement follow:]

CHART 1

REPRESENTATIVE SHORT-TERM AND LONG-TERM INTEREST RATES

(weekly averages, January 1982 to February 11, 1983)

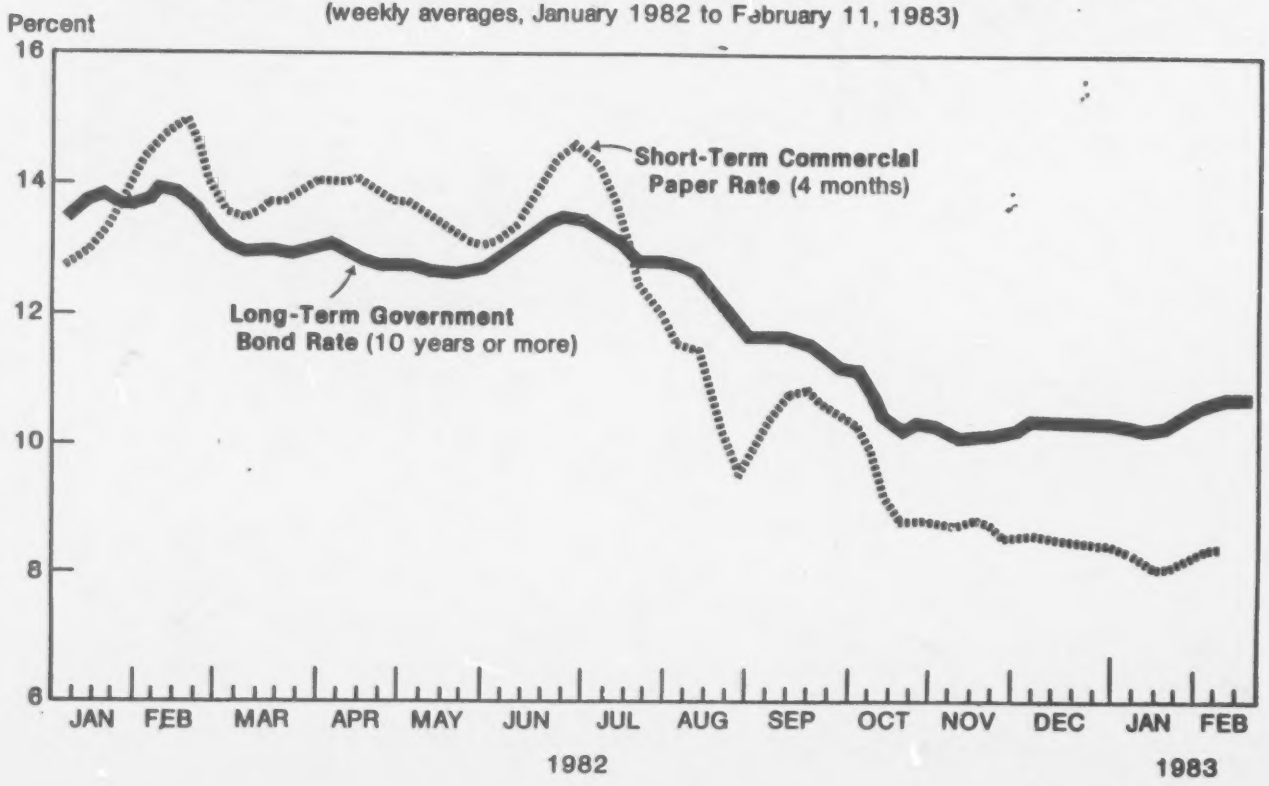
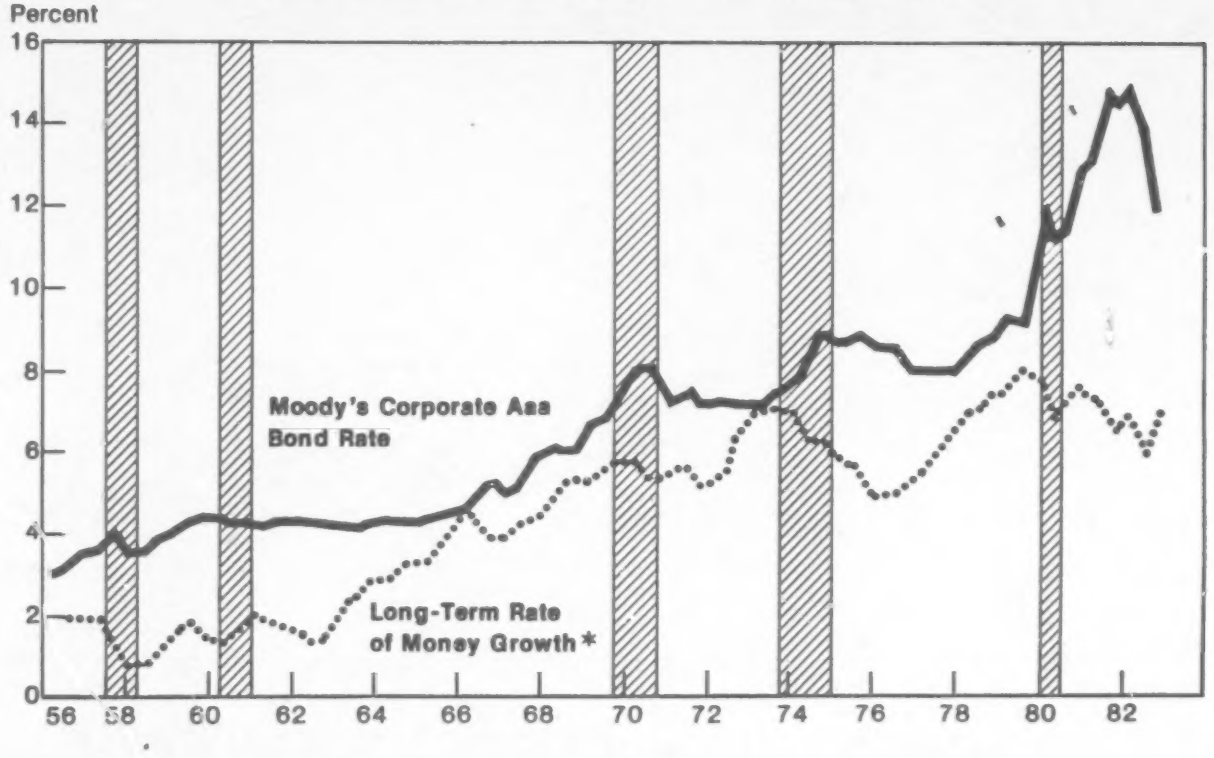


CHART 2

LONG-TERM MONEY GROWTH AND INTEREST RATES



*Money Growth is the rate of change in M1 over three years, expressed as an annual rate.

Shaded areas represent recessions.

The Chairman. Thank you very much, Mr. Secretary.

Senator Hecht, would you like to begin the questioning today?

Senator HECHT. Thank you Mr. Chairman. In your opening statement on the first page in the middle you said, "to maintain progress toward price stability while providing the money and liquidity necessary to support economic growth."

Mr. SPRINKEL. Yes, sir.

Senator HECHT. Last week we met with the homebuilding industry, real estate people, mortgage bankers, critizing the high interest rates, it's impossible to support economic growth, roughly 11 percent prime rate, obviously no one borrows at that but it's 2 or 3 points over. At this rate they cannot sustain economic growth.

How can you address that?

Mr. SPRINKEL. Well, I agree that interest rates are too high, any way you measure them. Especially if you try to deduct current inflation rates from the actual nominal rates, you get some very high numbers. The only way I know to address them effectively over the long run, and therefore encourage the investment that we all want, is to gradually, over time, convince the marketplace that this time, this Congress, this administration, and this Federal Reserve Board plans to get inflation down and keep it down.

That means to me moderate growth in the money supply. It also means efforts to get toward a balanced budget at some point in the years ahead.

Senator HECHT. What in your opinion is the time frame of this?

FURTHER DECLINE IN INTEREST RATES

Mr. SPRINKEL. Well, it's very difficult, first, to predict that those actions will be taken. But if they were taken, and taken consistently, I would expect that gradually over the next year or two we would see further declines in interest rates.

If we do the opposite—that is, the Federal Reserve opts for rapid growth in the money supply—that will certainly drive interest rates up because expectations of higher inflation would increase. If we make no progress on getting the deficit under control, that would work in the same direction.

But assuming we can work together—the administration, the Congress and the Federal Reserve—toward gradually slowing the inflationary pressures from monetary and fiscal policy, I think we can pull it off. We certainly have a great opportunity because actual inflation has come down greatly. What we want to do is to get expected inflation down in line with actual, and I do not believe that it's there yet.

Senator HECHT. If these homebuilders cannot start building again, and providing jobs and in reality bring money back into our Treasury, how can our revenues come up? Where are we? Do we want to get these people working again, producing, making profits, paying taxes, or do we want to keep them out of work?

Mr. SPRINKEL. We want to get them working obviously and paying taxes, and that's what most of them want to do. I'm quite confident that we are in an upward expansion in the economy. You're never absolutely certain until many months later, but the odds are extremely high, based on what's happened to leading indi-

cators, what's happened including housing starts, which rose sharply as you know last month to 1.7 million—including what has happened in terms of money growth; including what's beginning to happen on consumer spending; including what's probably happening on reversal of inventory liquidation. We're set for a significant economic expansion. That means more jobs.

This also is reflected, as you know, in the data on unemployment in the household survey, which went down last month. So I'm convinced that we are in an upward phase of the economy and our challenge is to make sure it continues and therefore adds jobs, without blowing it on the inflationary side or the restrictive side. It's a narrow path unfortunately, but I think we can do it.

Senator HECHT. Getting back to the homebuilders, a major part of our economy, they say that unless the prime rate, drop two more points, it will be very difficult for them to have growth. When do you see that happening?

Mr. SPRINKEL. If we avoid continued very rapid growth in money in the months immediately ahead but continue to have some moderate growth, I would expect it would happen this year. We have made enormous progress, as you know, in getting the prime rate down, but not enough. It's come from 21 to 11. That's not insignificant, but 11 is very high by historical standards. Normally, if you have a fully adjusted marketplace, you would expect to have a short-term rate that might show something like 1 percent real rate. That is, you subtract the inflation rate from the nominal rate and you get something on the order of 1 to 2 percent.

Now you don't get that today. You get a number a lot higher. But we don't know directly what inflationary expectations are. I personally believe they are much higher than the recorded inflation numbers. So there is lots of room for further decline in the prime rate, provided we can continue to gradually reduce inflationary expectations.

Senator HECHT. That's all for the moment, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Let me just follow up on that, Mr. Secretary. Your statement has been almost entirely concerned with monetary policy and your answer to Senator Hecht is you would expect that this year if we had a reasonably moderate growth in money supply. That does not take into account the actions of the Congress on fiscal policy and the $200 billion deficit, and I would disagree with you on that happening this year. Unless Congress in the fiscal 1984 budget starts to send some signals, I really don't care what Mr. Volcker does; I don't think you're going to see 2 percent lower interest rates; I think you're going to see higher interest rates. Would you agree with that, unless Congress starts to behave?

Mr. SPRINKEL. Well, I do not believe that either monetary or fiscal policy alone is the sole determinant of inflationary expectations, but together they clearly are the most important. So I do care what happens at the Fed, just as I care what happens on the fiscal policy front.

I think most observers would agree that the $200-plus billion deficit this fiscal year does not necessarily mean that we can't do something about it in subsequent years, but if you delay and delay

the action, it gets more and more difficult. So I certainly agree with you that we need to make progress on the fiscal policy front.

It turns out that historically, in most countries, nations that have run large deficits inevitably at some point in time, decide to finance it the easy way; that is, by creating more money. That is, in the short run, it seems to be the easy way. There have been periods in our history when we had large deficits and low growth in money. There have been other periods when we had low deficits and high growth in money. But if you look around the world, unless you get the deficits under some reasonable control, it typically does lead to excessive money growth.

The CHAIRMAN. Well, I agree that both must be addressed, but I happen to be of the view that the fiscal policy has been far more out of control. I would agree with you historically you can prove just about anything you want, deficits relate to money growth and so on, but you also—in talking about the interest rates going up and down and the trend upward, the same thing has happened with the deficits only at a much more rapid increase. I can't imagine 8 years ago when I first came to the Senate sitting here hoping that we could get the deficit down to $150 billion. I mean it was beyond my wildest expectations to even consider that because I never considered we would have $150 billion deficit at the top.

Mr. SPRINKEL. Right.

The CHAIRMAN. When you consider that in my 8 years we have gone—I was here when we surpassed a $300 billion budget in 1 year, so we have gone 3, 4, 5, 6, 7, 8 in the 8 years I've been here.

JOBS BILLS ARE TOO LATE

I would say that even Lord Keynes would be disgusted with what we are doing because when he talked about priming the pump during years of bad economic times he also talked about surpluses during good times. We have only been practicing half of Keynesian economics. The other half we haven't even addressed for years and that's why I feel so strongly that Congress is out of control. And I'm sorry, but I feel now the administration is yielding to that pressure once again with jobs bills that are too late. We're going to have a jobs bill that should have been 2 or 3 years ago. This recession will prime the pump after the pump doesn't need priming, after it's going by itself.

We had testimony on Friday that probably the best indicator that we were coming out of a recession was a jobs bill, and I would agree with that.

So I only emphasize how strongly I feel that, sure, they both have to go together, but the one that has really been out of control for a long number of years is Congress and apparently unwilling to get their act together again, and it's a trend line, not those individual comparisons year by year, but if the expectations are that those deficits are going to continue to grow over years, you haven't got a chance of lowering interest rates. If they will level off, yes, we can keep $200 billion deficits for a while if they are leveling off and starting downward.

Don't you think that trend line in deficits is the most important rather than individual years?

Mr. SPRINKEL. I certainly do, and there is no doubt in my opinion that the higher the deficits, with any given growth in the money supply, the higher the real rate of interest. The deficit has to be financed.

One of my jobs is to make sure it is financed. We can finance it by going into the marketplace and pushing away private borrowers. We'll be able to finance the Federal deficit, but is there going to be enough left for others to finance capital formation, to improve productivity? That's the real question and, of course, ultimately, unless we get the budget under control, there's a great risk that it would also exert unfortunate pressures on the Federal Reserve to increase the money supply at an excessive rate. So either way we lose. So I think it's important to move on both fronts. Yes, I agree with you.

The CHAIRMAN. Well, I agree, but in further finishing up Senator Hecht's questions, I just don't see that anybody, particularly in the long-term money markets, is going to be silly enough to give us reasonable stable lower fixed rate interest as long as they see that trend line in deficits going up, and I just don't see any other choice. They would be terribly foolish to continue to borrow short and loan long, which has gotten them all in trouble in the past.

Mr. SPRINKEL. That's one of the reasons, sir, that I think we are having some trouble in expectations reducing inflation. We have had 15 to 20 years now of movements in the opposite direction, and many investors in bonds remember the pain they suffered as interest rates went up and bond prices went down. They had a brief flurry over the last year and did very well, but that doesn't mean they're convinced that we're going to get inflation down and keep it down.

The CHAIRMAN. I'm just surprised that the markets have been as gullible for so long. I mean, you changed the faces. You changed some of the people. The speeches are the same from every new President and every new Congressman and every new Senator. They run in here and say they're going to balance the budget. They're all fiscal conservatives. We go through that every two years and it never happens. After two decades you'd think the market would have learned sooner.

So unless we start with actions, the words are cheap. We were talking about $45 billion deficits 2 years ago and some of us thought that was a little silly even to talk about those kinds of deficits; we were not realistic; you believed in the tooth fairy if you thought we were going to have $45 billion deficits in fiscal 1982. But why should the markets, anybody that has half a brain out there, believe these politicians that occupy the House and the Senate of the United States, or Presidents or administrations, after 20 years of saying what they were going to do? We simply have not matched our actions with our words. It's gotten worse and worse every year and all you get at the beginning of this year is the same old rhetoric that I've heard every year I've been in public office, just empty words from politicians who like to get on TV and perpetuate themselves in public office.

I wish I shared some of your optimism on what we could do on monetary policy, but I think the whole ballgame is with the fiscal policy because if we weren't having those long term deficits in

trend lines, as I said to Mr. Volcker, he wouldn't be very well known in this country and it would be easy to be Chairman of the Fed if you didn't have to monetize those debts. It's very easy to sit and do the things you have suggested we do today of taking a moderate monetary growth if you didn't have the wild fluctuations with a fiscally irresponsible Congress of the United States. It would be easy with the Fed. You wouldn't even have to have much training in economics. You could kind of guess and match up.

So I continue to try to establish who the real culprit is in this. It's the Congress, Republicans and Democrats; it's both parties, administrations of both parties, who simply have not learned the simple word "no" and so we continue to expand far, far beyond what is reasonable in our budget and our budget deficits.

Senator Mattingly, it's your turn if you would like to begin.

Senator MATTINGLY. Good morning.

Mr. SPRINKEL. Good morning.

IMPACT OF FALLING OIL PRICES

Senator MATTINGLY. I just noticed on last night's news the action taken by the OPEC dropping their oil prices. I would like to just have your opinion on what impact that's going to have on the debt servicing to a lot of countries in relation to the IMF funding, whether it will have some impact about the request for new money. Do you see a change possibly or will the request that we've put in so far for IMF funding, knowing the impact this may have?

Mr. SPRINKEL. Well, it's a very significant development, I certainly agree with you. The net balance, bottom line, is that the United States will benefit a great deal from this development. It makes possible greater economic growth.

Senator MATTINGLY. I understand all that part. I want the other part.

Mr. SPRINKEL. The other part, after the good things, there is some redistribution involved, not only domestically but especially abroad. Brazil will benefit a great deal. Mexico, of course, will have to adjust more than would have been the case if the price of oil had stayed where it was. There are other nations, such as Nigeria, that have difficulties, and Venezuela that will have a lot of difficulties. But most of, or all, of the nonexport LDC's will benefit, as we will benefit. But there will be other countries where the problem will be more severe and Mexico is one of them.

Senator MATTINGLY. I want to talk about the severity. That's what I was getting to. I know the good things. People will be happy at the gas pumps.

What impact will it have on the request for borrowing? It seems to me it's going to put any country who's a major oil exporter—they're going to have a liquidity problem it would seem to me.

Mr. SPRINKEL. You're right.

Senator MATTINGLY. I assume there has not been an analysis done yet. What would be your off-the-cuff analysis of what impact it may have?

Mr. SPRINKEL. Well, remember that if they want to borrow from the IMF—I believe that's what you were referring to——

Senator MATTINGLY. Right.

Mr. SPRINKEL. The nations involved must work out with the IMF a program and some of them that are going to be pained as a result of the cut in oil prices—Mexico, for example—their IMF program may have to be adjusted over time. It's not just a right that any nation can go to the IMF and get money. They must first correct their domestic economic policies take some time and in the event they are willing to make those adjustments, presumably loans will be made to them. But on the other hand, the nonoil LDC's should over time be able to improve their condition sooner than originally anticipated.

So it's very difficult to say off the top of my hat whether there are going to be more LDC countries benefit from the cut in oil prices than will be hurt. I suspect more will benefit, but there will be some major exceptions.

Senator MATTINGLY. Major like Mexico?

Mr. SPRINKEL. Mexico, Venezuela, Nigeria, and a few others around the world.

Senator MATTINGLY. Is there any idea about the number of countries that are going to be making requests to the IMF out of the 146 nations?

Mr. SPRINKEL. Well, we try to keep informed as well as we can, both by contact with the IMF and some of the nations bilaterally. It's practically impossible to predict with certainty. You can see the trends developing out there, but frequently there's great reluctance on the part of independent nations to go to the IMF until their access to funds are no longer available in the marketplace. Then they will go. It's unfortunate they wait that long, but they do.

Therefore, to answer your question specifically, do we know which countries are going to be coming? The answer is no. We have a few guesses. We have made various scenarios the worst-case scenario, the not-so-bad scenario to see what implications it has for IMF funding. I think the agreement we reached a couple weeks ago with our counterparts is a reasonable one. I do not expect that there will be the necessity of coming to Congress shortly and asking for an increase. I do not expect that at all.

Senator MATTINGLY. I know that you don't want to discuss the worst-case scenario and the best-case scenario for the borrowing countries, and I think it ranges anywhere from $1 billion to $3 billion, $3 billion being the worst case, but I just wonder now with the change in the price of oil, if that scenario has changed.

Mr. SPRINKEL. Some of them are going to be better off and some worse off. I have not bottomed it out in terms of dollars, but we would hope we could get some information on that fairly shortly.

Senator MATTINGLY. I hope you start doing that soon.

Mr. SPRINKEL. I don't know yet what the price of oil is.

Senator MATTINGLY. Everybody talks about the deficit. You still are of the opinion, I hope, that we ought to cut spending rather than raising taxes?

Mr. SPRINKEL. Yes, sir. I would like to slow down the rate of rise in Government spending. That was the objective when we came and I haven't changed that. It's difficult. As Senator Garn says, it's impossible——

Senator MATTINGLY. He says what?

Mr. SPRINKEL. Well, he says it's very difficult to cut Government spending and he almost said it was impossible.

Senator MATTINGLY. Senator Garn and I would agree.

The CHAIRMAN. You were lucky you missed my oration.

Senator MATTINGLY. I wasn't here, but maybe on entitlements?

The CHAIRMAN. Don't get me started on entitlements.

Mr. SPRINKEL. That reminds me of a statement that Mr. Churchill made many years ago and I can only paraphrase it, that democracy is a horrible system until you look at the alternatives.

Senator MATTINGLY. I haven't given up yet. I think he also mentioned something that's probably applicable to Government hearings. The two most difficult things to do or impossible—one was try to kiss your nose leaning over backward and trying to resolve a very difficult subject in 10 or 12 minutes, which sometimes is the way we feel when we're asking questions, but I will postpone any more questions at the moment.

The CHAIRMAN. Senator Hecht, do you have any more questions?

Senator HECHT. No.

The CHAIRMAN. Mr. Secretary, the overshooting of monetary targets is a broad and belated adjustment for the previous prolonged undershooting, but in your statement you didn't make any mention of the maturing and turnover of the all-savers certificates or the new money market accounts.

What impact do you think those structural changes have had and in any way are they ballooning up an apparent increase in the money supply?

INSTITUTIONAL CHANGES NOT RESPONSIBLE FOR BALLOONING MONEY SUPPLY

Mr. SPRINKEL. Well, they have a significant effect, there's no doubt about that. There is some dispute about whether the recent increase in money is mostly institutional change. But I do not believe most of the rise that's occurred in the money supply over the last 6 or 7 months has been due to institutional change.

Referring to the data behind that kind of argument, is the best way to look at what happened to the monetary base or to bank reserves. In either case, you find very rapid acceleration in recent months in reserve creation brought on by the Federal Reserve buying securities. So that was much of the money growth can be contributed to reserve creation, but another portion was the institutional change in recent months I'm sure that, over time, if we haven't seen the end of financial innovation, continue to make progress in deregulation, we will be able to permit the banks to provide even more attractive forms of deposits so that I don't know what the next move will be, but there will be one.

We do find typically that after a given deregulatory change for the first few months there is a large reallocation of the funds, then it tapers off. Most of those actions are behind us far enough now that I would expect that most of the adjustment has occurred. But there will be other regulatory changes that will cause such shifts in the future.

I think that the Federal Reserve has attempted to estimate what portion was of the money growth due to institutional change and

that's why they raised their targets. But they didn't double the targets, they raised them modestly. And by far the most important determinant of the rate of growth in the money supply in the immediate months ahead will be what they do through to open market operations to alter total reserves in the banking system.

The CHAIRMAN. But at least part of it was necessary for the Fed to accommodate during that transition period.

Mr. SPRINKEL. Yes, that's right.

The CHAIRMAN. Your background before you got into Government service is in banking and I asked the question twice in the hearings and tried to get an answer to the difference between long-term interest rates and short-term interest rates. I made the point very strongly that the expectation for inflation in the next year or two—you said that in your statement today that you would not anticipate within the next year that things would go up. And I have failed to understand why there is such a connection between short-term rates. If that's true, you'd think during a year or two when they don't expect it to change the short-term rates could be lower.

And I asked the question of the Chairman of the Fed last week if he felt the banks were profiteering, and probably that was an unfortunate choice of words—profiteering leads into all sorts of connotations which are probably not fair. But let me change the question to, are they artificially holding up their short-term rates, to make it sound nicer than profiteering?

Mr. SPRINKEL. Well, it's very difficult for an individual bank to do that. There's always some price-cutter in their midst if, in fact, there are sharp downward pressures or significant downward pressures on short-term rates. Unfortunately, short-term rates have not been coming down lately. They have been going up a little bit.

It would be unusual for a particular short-term rate—that is the prime rate—to be cut in an environment when others short-term rates are rising because that's the cost of money, cost of funds to them. They must, in essence, finance their assets through CD's or some other instruments, some of the new instruments, and those costs have not come down lately.

Now the higher the total cost of funds, including the perceived loan losses that may occur in the future, the higher the prime rate. It's mostly short-term financing costs that are the most influential factor and they have not come down lately.

The CHAIRMAN. You've been intimately involved in the negotiations over the IMF quota increase and the GAB and to what extent do you believe financial concerns over the international debt situation have kept interest rates higher than they should be?

Mr. SPRINKEL. It's very difficult to know, but it is a potential cost and this may have had some indirect effect. The fact that the 146 nations were able to reach an agreement on a reasonably sized financing package and that it is now in the legislative process here in the United States as well as elsewhere over time I would expect this to be a factor working toward lower rates because it does imply greater economic stability among countries and hence fewer potential loan losses than otherwise.

The CHAIRMAN. So are you saying that if Congress would act positively on the request of the administration, both on the IMF and GAB, that this would have a positive impact on interest rates?

Mr. SPRINKEL. I wouldn't want to make too strong a case for it, but it would work in that direction. By far, the most important things are the issues we talked about earlier; that is, trying to get our overall deficit down and also keeping money growth under control.

The CHAIRMAN. What's your opinion of the Fed postponing for another year going to contemporaneous reserve accounting rather than lag?

Mr. SPRINKEL. Well, we have been on record—at least I have been on record since being in Washington—urging that they move off lagged reserve accounting as quickly as possible. We were very pleased to see them moving toward contemperaneous reserve accounting, but it's now been delayed I gather until sometime next year. The reason I personally and many others in the administration, were in favor of it was because it would give the Federal Reserve much more precise control over reserve creation and hence over money creation. But they have chosen for various operational reasons, I presume, to delay it.

The CHAIRMAN. Well, I have pushed them to do it too and I'm very disappointed that they wouldn't go ahead with it, but to delay it another year, I fail to see the reasoning beyond that where they want to have more control.

Do you have any idea why they think it's too unsettling at this time to make a change?

Mr. SPRINKEL. I'm not certain. It does indeed raise some costs in the banking community and it varies of course by individual banks. This may have been part of the reasons but I'm not certain. If it were a part of the reason for not adopting contemporaneous reserves, this, in essence, is saying that a public objective is postponed because of the private cost involved. A way to prevent that would be some very slight reduction in reserve requirements, which are also costs to the banks. This in essence, would make it a public cost and I, for one, would be in favor of a public cost being incurred to achieve what I believe is an important public objective. So even though that may have been part of the argument, it's not a very persuasive one in my mind.

CONSEQUENCES OF RESTRUCTURING

The CHAIRMAN. There's been a great deal said in these hearings not only from those on monetary policy but the housing hearings we held a week ago about the competitive inequities which may result from the restructuring we have been doing in the financial community. What do you see as the potential consequences of restructuring to the efficiency of our credit markets and the Fed's ability to conduct monetary policy?

Mr. SPRINKEL. Well, none of those changes have affected the Fed's ability to create reserves or base money, whichever you prefer. It does create noise in the money supply data and may make it more difficult to know for sure, in the short run what's happening. However, we should not lose sight of what our overriding objective is and that is to make this system more efficient. That is to offer more and cheaper financial services to the American public and I think that is clearly happening. I do not believe that

very laudable objective should be derailed by concern about what it may do to the M's in the short run because it does nothing to reserve creation; it does nothing to interfere with base control; It does make movements back and forth between the various M_1, M_2, M_3, et cetera, a little more intense in the short run.

The CHAIRMAN. I assure you I'm not deterred.

Mr. SPRINKEL. I knew you weren't.

The CHAIRMAN. I'm just beginning. The bill last year was just beginning trying to modernize the system and obviously in transition periods again there are some rough times.

Mr. SPRINKEL. Yes, sir.

The CHAIRMAN. But some of the worst critics, when you ask them if they want to go back to what they were, to the sweep accounts and all the other maneuverings they were involved in trying to survive and keep some money in their institutions, nobody wants to go back. They just want to criticize.

Mr. SPRINKEL. Some of them would like to stop where they are now perhaps.

The CHAIRMAN. Yes. That's probably true, but we will continue to press forward.

Mr. SPRINKEL. We certainly will also.

The CHAIRMAN. Senator Mattingly, do you have additional questions?

Senator MATTINGLY. Getting back to the contemporaneous reserve requirements, in 1981 or 1982—I forget which committee—we were proposing that they institute this tool. It seems to me the targets they set are never going to be any good until they implement some additional tools and contemporaneous reserve requirements is a tool.

What does it take to get them to utilize this tool?

Mr. SPRINKEL. Well, we have from the very beginning urged them——

Senator MATTINGLY. You mean the Treasury Department?

Mr. SPRINKEL. Yes. We urged it in public before this and other committees. As you know, the Federal Reserve reports to the Congress, not to the Treasury, and I presume it's up to Congress and their own decisionmaking process when they adopt it. The sooner, the better, from our point of view.

Senator MATTINGLY. Well, let me ask the Chairman, can we get the Congress to legislate the Federal Reserve to do it? I don't think we can.

The CHAIRMAN. Well, we could, but as much as I would like to see them make the change I would not want to do it by legislation. I don't think that is the way to proceed. That opens the door to when we start legislating to the Fed all sorts of little things and I think that would be a disaster. Despite my problems with the Fed over the years, I don't want Congress dictating every dotted "i" and crossed "t" of how they operate. Then we would think that a return to present Fed policy would probably be very desirable.

Senator MATTINGLY. Probably true. They have consistently overshot the targets which means obviously the targets——

The CHAIRMAN. I might just say that the first year I was on the committee and sat over there where Senator Hecht is, that there were proposals in both the House and the Senate to set the money

aggregates by legislation and Arthur Burns sat there chewing on his pipe and said, "Now, Senator, you know better than that," and I can't imagine what condition the economy would be in today if rather than—I think the targets were 5 or 7 percent or something like that and we were talking about mandating 12 to 15 percent, an increase in the M's, and you would have thought a 21.5-percent prime rate was giving money away, if Congress had gotten involved in that. And you can imagine legislating the money supply on a year-by-year basis or even in very general targets. So I'd like to see them go to contemporaneous reserve accounting, but you could open Pandora's box with Congress legislating and dictating to the Fed that I would not favor.

Senator MATTINGLY. I agree with that. I don't think we should legislate either. But if we've got everybody in agreement that that's what they ought to do—and I haven't heard any disagreement about doing it other than the objections coming from the Federal Reserve itself—and saying that it's under consideration but we may use it late—to me that's—we've been waiting a long time and since they've not met their targets for so long, it seems to me they may want to look at another tool. Maybe we should just send a letter down once a week to them.

The CHAIRMAN. Well, I think one of the things obviously I was asking Secretary Sprinkel, I do believe the industry itself feels that to enact it rapidly would impose costs on them and they prefer to have it—they don't disagree to going to it eventually, but they prefer to stretch it out. So that may be one of the major reasons for the Fed, because the financial industry itself not wanting to absorb that change along with all the other changes that are happening right now. But it's sort of like changing to the metric system. In my opinion, if we had done it 50 years ago, nobody would care. The longer you wait, the more difficult it becomes.

Senator MATTINGLY. I've spoken to some of the regions—I won't say which ones—but some of the Federal Reserve regions and they are all for it. So it's sort of surprising—not surprising but——

I have one other question. I don't know whether your Department should do the analysis, but at what price of world oil do you think would have to come down to where it's going to impact the oil countries not being able to service their debt? Now I don't think it's a complicated question because I think we've got the information here in our country about what percent oil is of the GNP of a set country, so you would have a quick analogy. So I was wondering if there might be some way you could gather some of that information, some ballpark figures for us.

Mr. SPRINKEL. We have looked at it to some extent and the estimates indicate that a $5 cut in the price of oil would permit something on the order of a half of 1 percent more economic growth, and that's an enormous amount. And I wonder if that's too generous myself because if the long-term trend in wealth is say 3 percent, increasing that to 3.5 percent is a high percentage increase and I don't know whether it would be that much or not, but I've seen estimates that high and higher. We would be glad to give you what information we have, but I don't feel very comfortable with it at this stage. We don't know how far oil prices are going to decline for sure.

Senator MATTINGLY. Well, we know they're on the way down.

Mr. SPRINKEL. Right. We think so.

Senator MATTINGLY. Now in the case of Mexico, owing something like $80 billion or whatever it might be, what price does their oil have to come down to to where they wouldn't be able to service that debt, $20 or $25 a barrel?

Mr. SPRINKEL. Well, I'm quite confident, based on discussions with them, they would not be much concerned about modest declines in oil prices, but if it gets to $5 or more per barrel it will make a big difference.

Senator MATTINGLY. They're not going to get more; they're going to get less.

Mr. SPRINKEL. That's right.

Senator MATTINGLY. If they get $5 less, where is the point where they're not making any money in order to put it in the coffers in order to service the debt?

Mr. SPRINKEL. I think what it means is that it will take longer for that nation to restore economic stability and it will be somewhat more costly to restore economic stability, but at least they are dedicated—the individuals that I have worked with—to doing just that, even if the price of oil comes down.

Senator MATTINGLY. Is there a price in there where they wouldn't be able to service their debt?

Mr. SPRINKEL. Well, it depends on an awful lot of things obviously on whether or not they are able to meet their targets with the IMF and therefore get some financing from the IMF. It depends on whether or not private credits——

Senator MATTINGLY. If they're not making any money at all and you get money from the IMF, all of the IMF money is going to do is turn the money back and pay the interest, and that would be—I think that's probably the scenario that we have to wonder whether that's money being spent well.

ALL LOANS BY IMF REPAID

Mr. SPRINKEL. There's no record yet of a loan by the IMF that didn't get repaid. That doesn't say it couldn't happen but the reason that's never happened, I'm convinced, is that an IMF program is respected and highly regarded by the private market because they do their homework. They try to decide whether or not this is a doable program and once they say it's doable, private funds become available. Of course, if you did not pay off a loan to the IMF, you're sort of doing the unpardonable. So they always pay back the IMF. But there is no doubt that the decline in oil prices will make it more difficult for Mexico to meet its obligations on the private and the public sector debt. But I'm not willing to say yet, based on our evidence, that this obviously means it's not going to work. I think it will work. It will just take longer.

The CHAIRMAN. Senator Hecht.

Senator HECHT. I appreciate your comments and I hope interest rates do come down two or three points by the end of the year.

Mr. SPRINKEL. I do, too.

Senator HECHT. I have absolute confidence that the private sector will revitalize our economy without a jobs bill and provide the revenues, so I appreciate those comments.

Mr. SPRINKEL. Thank you, sir.

The CHAIRMAN. Senator Mattingly, did you remember your question?

Senator MATTINGLY. I sure did. I'm not advocating it, but with the price of oil coming down, if it does come down appreciatively, and people are unable to service their debts, would it then be plausible to consider using sort of barter type transactions? I don't mean to keep pounding on this.

Mr. SPRINKEL. Well, of course, the barter system has been used by some countries that have got into great difficulty. It's a very inefficient system. It's not nearly as efficient as the marketplace, but nonetheless, if in the event the nation gets into great difficulty and for some reason is unable or unwilling to adjust their exchange rate to properly reflect reality—as the Brazilians did incidentally over the weekend—then that's the next step. It's not something I would encourage, but it's something that has developed on occasion in the past and I'm sure it will in the future.

Senator MATTINGLY. By the way, have you analyzed the AFL-CIO jobs program?

Mr. SPRINKEL. No, sir; I have not.

Senator MATTINGLY. $68 billion? I thought Senator Garn might want to comment on that.

The CHAIRMAN. I'm glad to hear that. I heard $75 billion. That's a reduction of $7 billion.

Senator MATTINGLY. It's a short year.

The CHAIRMAN. Do neither of you have additional questions?

[No response.]

The CHAIRMAN. Mr. Secretary, thank you very much for your time before the committee today. There will be additional questions for your response in writing.

Mr. SPRINKEL. Very good.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 10:35 a.m., the hearing was adjourned.]

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